CHAPTER 8

Review and Outlook

ECONOMIC DEVELOPMENTS IN 1981 reflected the inflationary economic policies of more than a decade and the transitory effects of reversing those policies. Past policies alternated periodically between short-run efforts to reduce unemployment and short-lived attempts to fight inflation. Economic forecasting, however, was not sufficiently accurate to produce finely tuned countercyclical policies that made proper allowance for the lag between policy actions and their effects. Stimulative policies had relatively immediate effects on employment, followed by delayed effects in the form of higher inflation. Restrictive policies for fighting the inflation were not seen by the public as part of a credible long-term commitment and therefore were not expected to be sustained. Consequently, they tended to have a more severe impact on output and employment than on inflation. The result has been a ratcheting-up in the trend rate of inflation from one cycle to the next.

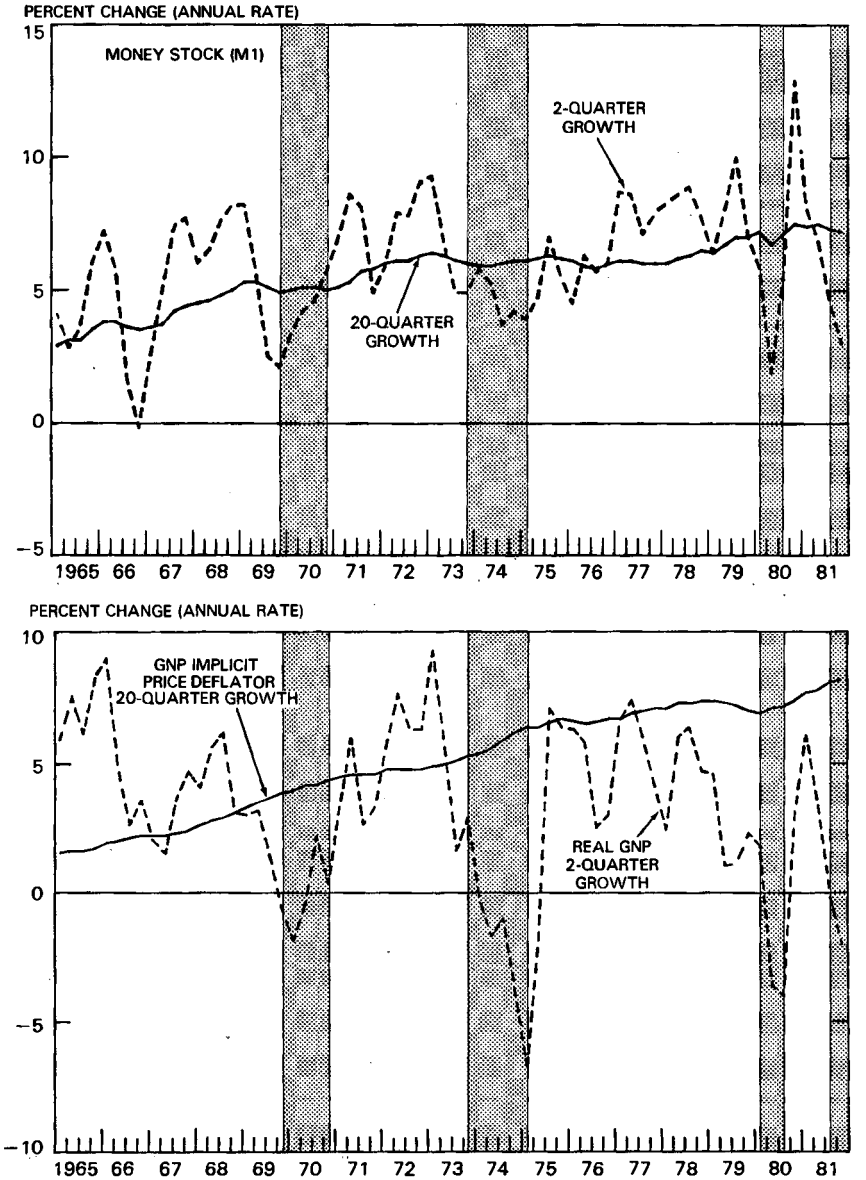
This legacy of stop-and-go policies prevented a direct move to lower inflation and higher real growth in 1981. During the first half of 1980, restrictive policies—in the form of credit controls and a sharp reduction in monetary growth—had produced a brief, sharp recession. The subsequent removal of these controls and a postwar record high rate of monetary growth then led to an unsustainable rate of economic expansion through early 1981.

OVERVIEW OF 1981

The historical patterns of monetary growth, inflation, and real output are shown in Chart 8-1. The average growth of money over 5-year periods (solid line) has trended upward since the 1960s; this is reflected in the rising rate of inflation. The two-quarter growth rate of money (dashed line) has fluctuated sharply, compared to the underlying growth trend, and has contributed to rapid expansions and contractions of real economic growth, after a one- or two-quarter lag. Variations in money growth result in changes in spending and nominal income growth. During short periods, such changes show up as changes in real income growth since inflation responds to money growth only after a considerable lag.

Chart 8-1

Growth Rates of Money Stock, Real GNP, and GNP Deflator



NOTE.—BASED ON SEASONALLY ADJUSTED DATA. SHADED AREAS INDICATE RECESSIONS AS DEFINED BY THE NATIONAL BUREAU OF ECONOMIC RESEARCH.

SOURCES: DEPARTMENT OF COMMERCE AND BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM.

This pattern held true in 1981 as well. In the last half of 1980 the money stock, as measured by M1, rose at a 12.9 percent annual rate, a postwar record. Then, in the first quarter of 1981, the rate of growth in nominal gross national product (GNP) leaped by 19.2 percent, with growth in real output rising 8.6 percent. Money growth in the first two quarters of 1981 receded to a 6.9 percent rate, followed by a further reduction to 3 percent in the final two quarters. These decelerations in monetary growth led to a sharp decline in real output in the final quarter of the year.

Continued business investment demand and high inflation in early 1981 sustained a rise in short-term interest rates, which peaked during the spring. Long-term interest rates peaked in early fall. These increases had their most adverse effects on the most credit-sensitive industries—housing, consumer durables, and, to a lesser extent, business investment. The sharp reduction in money growth in the summer and fall led to a sharp decline in total output and interest rates. By December 1981, short-term interest rates were about 5 to 6 percentage points lower than in December 1980, while long-term interest rates were about one point higher.

The average level of real GNP in 1981 was 1.9 percent higher than in 1980, but this increase for the year as a whole masked a pattern of declining output for two of the final three quarters. After growing at an unsustainable rate in the first quarter, the economy remained on a plateau for a time: a modest annual rate of decline of 1.6 percent in the second quarter and an increase of 1.4 percent in the third. In the final quarter the economy dropped sharply, with real GNP declining at an annual rate of 5.2 percent.

The unemployment rate at the close of 1980 had been 7.3 percent, and it averaged around 7.4 percent through the first 9 months of 1981. But the weakening of the economy in the last quarter brought with it a rapid increase in the unemployment rate to 8.8 percent in December. Civilian employment grew slowly, from 99.6 million at year-end 1980 to over 101 million by May 1981, before dipping to 99.6 million at year-end 1981.

Meanwhile, however, the deceleration in monetary growth began to produce declining inflation in 1981. The growth of M1 slowed to 4.9 percent during 1981, compared to an average growth rate of 7.8 percent over the previous 4 years. The GNP deflator advanced 8.6 percent through 1981, down from 9.8 percent during the four quarters of 1980, while the consumer and producer price indexes slowed more sharply. The producer price index for finished goods, which had risen 12.4 percent during 1980, rose at a 10.1 percent annual rate in the first two quarters of 1981 and at only a 4.4 percent rate in the last two quarters.

TABLE 8-1.—*Performance in 1981 compared to January 15 projections*

Item	Projected	Actual	Projected	Actual
	Year to year		Fourth quarter to fourth quarter	
Percent change:				
Real GNP	0.9	1.9	1.7	0.7
Consumer price index [1]	12.5	10.2	12.6	9.4
	Year		Fourth quarter	
Level:				
Unemployment rate (percent)	7.8	7.6	7.7	8.3

[1] Consumer price index for urban wage earners and clerical workers.

Sources: Actual data: Department of Commerce (Bureau of Economic Analysis) and Department of Labor (Bureau of Labor Statistics); projected data: Office of Management and Budget (January 15, 1981).

As shown in Table 8-1, the average performance of the economy in 1981 was better than had been predicted by the prior Administration. Actual real GNP in 1981 was 1.9 percent higher than in 1980, compared with a 0.9 percent growth rate forecast by the prior Administration. Consumer prices in 1981 exceeded their 1980 level by 10.2 percent, but this was significantly less than the 12.5 percent rate of inflation that had been forecast. In addition, the average rate of unemployment for 1981 turned out to be 0.2 percentage point less than had been forecast. However, real growth from the fourth quarter of 1980 to the fourth quarter of 1981 was lower than forecast, and unemployment in the fourth quarter of 1981 was greater than forecast as a result of the decline in output and employment late in the year.

Although the Administration was able to effect some reductions in the growth of Federal spending in fiscal 1981, such spending as a share of GNP continued to rise. In nominal terms, Federal spending growth (including off-budget outlays) in 1981 slowed to 14.8 percent, from 17.4 percent in fiscal 1980, one of the largest peacetime increases in history.

The real Federal tax burden was increased by the scheduled payroll tax increase on January 1, 1981, and the tax burden drifted upward during most of the year as inflation contributed to higher nominal incomes and rising marginal tax rates. The Economic Recovery Tax Act of 1981, however, provided an initial 5 percent cut in marginal tax rates for individuals, effective October 1. This had the effect of reducing marginal tax rates by only 1¼ percent over the full 1981 tax year, not large enough to prevent a substantial increase in the total tax burden. For business, however, many of the changes in the tax code were retroactive to the beginning of the year.

Since tax revenues as a share of GNP will decline by about 2 percentage points over the next few years and budget outlays will not yet have been reduced as much, large Federal budget deficits can be expected unless the growth of Federal spending is reined in even

more. The possibility of large deficits received much attention in the financial markets during 1981. The concern was that these deficits might engender an acceleration of inflation and higher interest rates. Fear of inflation kept long-term interest rates at high levels, although some decline did occur in the final months of the year.

In the climate of high interest rates, investments in money-market funds provided savers with some of the highest yields in history. Many thrift institutions were not able to compete successfully for deposits, and the resulting outflow of funds contributed to a reduction in the availability of mortgages and construction financing. Mortgage rates on new homes remained above 15 percent throughout 1981. In consequence, home sales and housing starts were among their postwar lows. The motor vehicle industry also suffered from the high cost of credit.

MAJOR SECTORS OF AGGREGATE DEMAND

Mirroring the small expansion in real output during 1981 was the slow expansion in the real growth of consumer expenditures (1.2 percent), business fixed investment (1.4 percent), and total government purchases (1.2 percent). Purchases of consumer durables declined 4.4 percent, partially offsetting modest gains in purchases of other consumer items. As shown in Table 8–2, residential construction decreased by a dramatic 21.9 percent. Net exports also declined last year, as real exports declined 1.0 percent while imports increased 9.5 percent.

TABLE 8–2.—*Growth in major components of real gross national product, 1977–81*

[Change, fourth quarter to fourth quarter]

Component	1977	1978	1979	1980	1981[1]
Percent change:					
Real gross national product	5.8	5.3	1.7	−0.3	0.7
Personal consumption expenditures	5.0	4.8	2.0	.6	1.2
Business fixed investment	13.5	9.0	2.9	−4.3	1.4
Residential fixed investment	12.5	−.0	−6.1	−12.9	−21.9
Government purchases of goods and services	3.6	1.6	1.9	1.6	1.2
Federal	5.0	−1.3	2.1	4.1	6.6
State and local	2.7	3.3	1.7	.1	−2.0
Real domestic final sales [2]	5.9	4.4	1.7	−.3	.4
Change in billions of dollars:					
Inventory investment	5.9	2.3	−11.3	−6.5	15.7
Net exports of goods and services	−5.5	12.6	11.7	6.3	−11.8

[1] Preliminary.
[2] GNP excluding change in business inventories and net exports of goods and services.

Source: Department of Commerce, Bureau of Economic Analysis.

Although the rising costs of borrowing discouraged purchases of consumer durables, growth in personal income was sufficient to sustain purchases of nondurables and services. The latter categories managed to show a modest increase for the year. But durables purchases (approximately 20 percent of which are expenditures on new autos) exhibited sharp swings from quarter to quarter, with the fourth quarter level 4.4 percent below the same quarter in 1980. The slow pace of durables purchases ensured a modest improvement in the consumer debt burden, as the ratio of consumer installment credit to personal income declined from its recent peak in May 1979 of 14.9 percent to 13.2 percent in November. The personal saving rate, after dropping one-half of a percentage point to 4.6 percent in the first quarter, recovered somewhat in the next two quarters and rose sharply to 6 percent in the final quarter of the year.

Real expenditures on consumer durables declined for the third consecutive year. The pace of durables purchases had been stalled by the imposition of credit controls in the first half of 1980, but rebounded sharply in the last two quarters of 1980 and the first quarter of 1981. Then came the termination of rebates on auto sales and rapidly rising interest rates, resulting in a sharp 23.3 percent reduction in durables purchases at an annual rate in the second quarter. A moderation in interest rates in the third quarter, in conjunction with factory subsidized financing and further rebates, then helped to stimulate auto sales, allowing outlays for consumer durables to rise moderately. Although the fourth quarter saw a significant drop in interest rates, it was not enough to boost total durables purchases. The result was another steep decline in such purchases, this time at a 19.2 percent annual rate.

At the beginning of 1981 new cars were being sold at an annual rate of about 10 million units, some of this relatively high volume being attributable to manufacturers' rebates. In the second quarter sales dropped to an annual rate of 7.8 million units; they then rose to 9.1 million units in the third quarter, before falling to 7.4 million units in the final quarter. Sales of American cars accounted for about 73 percent of all U.S. car sales for the year. In order to defuse protectionist pressures in the United States, the Japanese government instituted an export restraint program, which limited Japanese car exports to the United States to 1.68 million units during its first year. Because of the weak U.S. market, however, the limit probably has not been binding.

RESIDENTIAL INVESTMENT

Investment in residential structures during 1981 continued a decline that started in 1979. The decline was evident in the construction of both single-family homes and multiple units. By the fourth quarter of 1981, starts of new single-unit structures had declined 44.8 percent below their year-earlier level, and multiple-unit construction declined 34.5 percent. In the last quarter of 1981 the inventory of new private homes waiting to be sold was about eight times the monthly sales pace. During the latter half of the 1970s the inventory-sales ratio typically was less than that, approximately six times sales.

The continued slow pace of residential construction was primarily due to tightness in the financial markets in which the housing industry competes for funds. Mortgage rates on new homes rose to over 18 percent in October, up from 15 percent at the beginning of the year. By year-end, however, the rate had fallen to 17 percent.

Home purchase prices were essentially unchanged during 1981. Thus, there was a significant decrease in the real price of housing—that is, housing prices in relation to the general price level. In contrast the rapid increase in house prices from 1977 to 1980 had reflected rising expectations about inflation and a growing tendency to view real estate as a good hedge against inflation.

BUSINESS FIXED INVESTMENT

Real business fixed investment finished the year above the previous year's fourth quarter level. This fact, however, masks the underlying variations that occurred during the year. Business investment varied from quarter to quarter in the same direction as real GNP, but the percentage deviations were much larger. Real business investment rose at a 13.3 percent annual rate in the first quarter of 1981, remained relatively flat in the second and third quarters, and then fell 10.9 percent in the fourth quarter.

Producers' durable equipment was responsible for most of the variation in business fixed investment, with fleet sales of cars and trucks accounting for a large part of this instability. The structures component of investment maintained a steady increase that began in the fourth quarter of 1980. Though investment in structures is less than half as large as investment in producer's durable equipment, its increase of 7.5 percent from the fourth quarter of 1980 to the fourth quarter of 1981 more than offset the decline in the latter, allowing a modest increase in total real business investment.

INVENTORY ACCUMULATION

Inventory levels at the start of 1981 were lean. Real business inventory levels in the fourth quarter of 1980, after declining for four of the five previous quarters, were equivalent to 2.7 months of output. In the first quarter of 1981, real output rose to nearly match final sales so that the real level of inventories declined only $1.4 billion at an annual rate. In the second quarter inventory accumulation was led by a rise in new car inventories, and there was also some buildup in other stocks in the third quarter. The speed with which output declined in the fourth quarter prevented an excessive accumulation of stocks at year-end.

NET EXPORTS

Economic growth abroad was subdued during 1981, contributing to a small decline in real exports from the United States. In contrast to 1980, the volume of non-oil imports grew briskly during the year due in part to the steady appreciation of the dollar from the latter part of 1980 through August 1981. For the year as a whole, net exports (measured in 1972 dollars) slipped $7.7 billion below the level of 1980.

Measured in current dollars, the merchandise trade deficit (NIPA basis) increased $4.2 billion from the $27.7 billion registered for 1980. Merchandise exports increased moderately in the first quarter and then declined to post a small gain for the year, while merchandise imports rose during most of the year. Growth in the value of agricultural exports was weak, as a strong U.S. dollar and better harvests abroad dampened foreign demand. The strong growth in the value of imports of nonpetroleum products was only partly offset by a drop in imports of petroleum and related products. Average net oil imports in the first three quarters of 1981 fell to their lowest level since 1972, partly as a result of reduced domestic consumption. That, in turn, was due primarily to higher oil prices.

Net service inflows for 1981 increased $4.8 billion over 1980 to $55.8 billion. Almost all of this increase was due to a rise in net receipts of factor income. This continued strong performance on the service account produced an overall net export surplus for 1981 of $23.8 billion in current dollars.

THE FARM ECONOMY

Record large crops, sluggish demand for farm products, high interest rates, and a nearly constant tonnage of agricultural exports limited the recovery of farm incomes and created cash flow problems for some farmers during 1981. In nominal terms, farm exports totaled a

record $43 billion in 1981; however, the tonnage of farm exports for the year was about the same as in 1980.

According to Department of Agriculture forecasts, net farm income for 1981 in current dollars will be approximately $23 billion. This figure is about $3 billion higher than the comparable income figure for 1980, but approximately $10 billion lower than the total for 1979, which was a prosperous year for U.S. farmers. For 1981, real net farm income is forecast to exceed the 1980 total by about 4 percent. The value of large crop inventories, which is reflected in the 1981 income figures, accounts for part of the increase.

Large grain stocks and weakness in the demand for certain livestock and crop products are expected to exert downward pressure on farm prices and net farm incomes during much of the first half of 1982, but the expected recovery of the economy should expand the demand for farm products during the final two quarters of 1982. Also, farm price support payments provided under the Agriculture and Food Act of 1981 will supplement the incomes of farmers during 1982.

The statistics on aggregate farm income mask how different groups of farmers fared during 1981. Farmers carrying small amounts of debt experienced a less severe cash flow squeeze than highly leveraged operators. Many in the latter group had cash flow problems because of high interest rates and lower commodity prices. However, some farmers who experienced cash flow problems used equity accumulated from rapid appreciation of their farmland to refinance their operations. As usual, income earned by farmers from off-farm sources, which recently has comprised over 60 percent of the average farmer's income and a substantially larger share of the income of small farmers, supplemented farm incomes.

Food prices generally exerted a moderating influence on the consumer price index during 1981, although two minor supply shocks produced temporary increases in food prices. The first was a mid-January freeze in Florida, which pushed up prices for citrus products and tomatoes last winter and spring. The second was a reduction in meat supplies during the summer. Food prices for the fourth quarter of 1981 were 5.0 percent higher than in the fourth quarter of 1980. This increase was 5.2 percentage points less than the comparable year earlier figure.

The moderate increases in food prices largely reflected supply phenomena. Supplies of many raw food products, including poultry, dairy products, sugar, and grain were abundant during 1981, as were beef supplies during the first half of the year. Data available so far suggest that marketing costs, which account for about two-thirds of

every dollar spent for food, were about 9 percent higher for the fourth quarter of 1981 than a year earlier.

LABOR MARKET DEVELOPMENTS

Changes in employment during 1981 lagged slightly behind changes in real output. Total civilian employment during the year reached a peak of 101 million workers in May before declining to 99.6 million at year-end. The ratio of civilian employment to the total noninstitutional working-age population also declined in the last half of the year. Declines in employment during the year were initially limited to interest-sensitive sectors, such as motor vehicles and residential construction and their suppliers. By the end of 1981, however, the decline had spread to other manufacturing industries as well. The overall unemployment rate, which was 7.4 percent at the beginning of last year, fluctuated between 7.2 and 7.6 through September, then rose sharply to 8.8 percent in December.

TABLE 8-3.—*Labor market developments, 1977-81*

Component	1977 IV	1978 IV	1979 IV	1980 IV	1981 IV
	Percent change from year earlier [1]				
Increase in civilian employment (16 years and over)	4.5	3.8	2.3	−0.2	0.6
Males 20 years and over	3.5	2.7	1.5	−.6	.2
Females 20 years and over	5.4	5.6	4.0	1.6	2.8
Both sexes 16–19 years	8.0	2.7	−.8	−6.6	−8.9
White	4.4	3.3	2.2	−.1	.6
Black and other	5.2	7.3	3.3	−.6	.1
	Percent [2]				
Unemployment rate (16 years and over) [3]	6.6	5.9	6.0	7.5	8.3
Males 20 years and over	4.8	4.1	4.4	6.3	7.2
Females 20 years and over	6.7	5.8	5.7	6.7	7.2
Both sexes 16–19 years	16.6	16.3	16.2	18.2	21.1
White	5.7	5.1	5.2	6.6	7.3
Black and other	13.2	11.5	11.2	13.8	15.4
Participation rate (16 years and over) [4]	62.6	63.5	63.8	63.7	63.8
Males 20 years and over	79.9	79.9	79.6	79.3	78.9
Females 20 years and over	48.6	50.1	51.0	51.5	52.3
Both sexes 16–19 years	56.7	58.2	57.9	56.3	54.6
White	62.8	63.6	64.0	64.0	64.2
Black and other	61.2	62.4	62.3	61.9	61.5

[1] Changes for 1978 IV adjusted for the increase of about 250,000 in employment and labor force in January 1978 resulting from changes in the sample and estimation procedures introduced into the household survey.
[2] Seasonally adjusted.
[3] Unemployment as percent of civilian labor force.
[4] Civilian labor force as percent of civilian noninstitutional population.

Source: Department of Labor, Bureau of Labor Statistics.

As Table 8-3 indicates, employment growth during 1981 varied considerably by demographic group. Adult female employment rose by 2.8 percent, while adult male employment rose by 0.2 percent; teenage employment fell by a dramatic 8.9 percent. The unemploy-

ment rate for adult men, who tend to work in disproportionate numbers in cyclically sensitive industries, rose from 6.1 percent in December 1980 to 7.9 percent in December 1981. The unemployment rate for adult women, who work in industries that exhibit more cyclical stability, rose 0.7 of a point, from 6.7 percent to 7.4 percent, during the same period. The teenage unemployment rate increased, from 17.8 percent to 21.5 percent, over the year.

The age-sex composition of the unemployed depends on the unemployment rates of different demographic groups and on their share of the total labor force. Teenagers, for instance, have relatively high unemployment rates, but in December 1981 they comprised only 7.9 percent of the labor force. Adult men have relatively low unemployment rates, but in 1981 they constituted 52.8 percent of the labor force. Thus, 19.4 percent of the unemployed in December 1981 were teenagers, 47.5 percent were adult men, and 33.2 percent were adult women.

The unemployment insurance system is designed to moderate the financial burden placed on experienced workers who lose their jobs by providing income until they can find employment. However, the system does not cover recent entrants to the labor market or workers who quit their jobs voluntarily. In December 1981 the number of individuals receiving unemployment compensation was 41 percent of the total unemployed. This was partly because 44.2 percent of the unemployed had left their jobs voluntarily or had no recent work experience. Over two-thirds of the people who had lost their jobs involuntarily were receiving unemployment benefits.

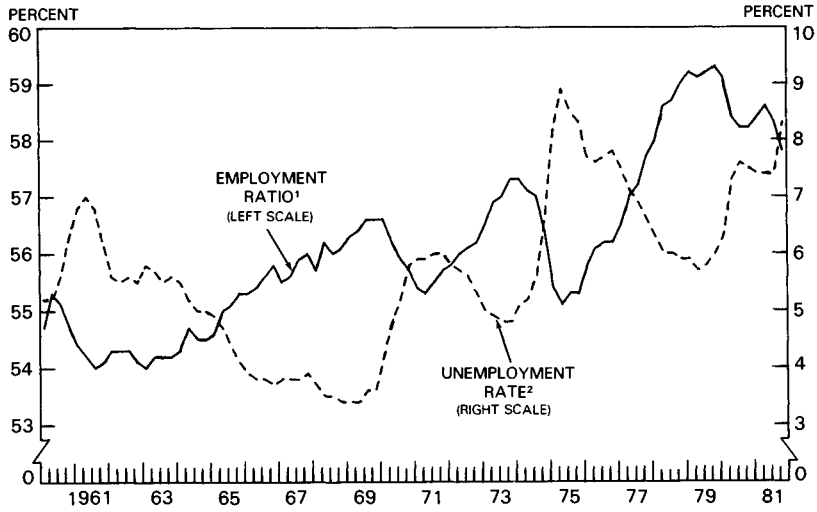
The percentage of take-home pay replaced by unemployment benefits varies widely according to an individual's weekly earnings, marginal tax rate, and State of residence. Replacement rates are generally higher for lower paid workers than for higher paid workers. However, several studies suggest that the average replacement rate is about one-half of take-home pay.

A combination of cyclical and secular trends produced disparate changes in labor force participation rates during 1981. Labor force participation rates continued to increase for adult women, and by the fourth quarter 52.3 percent of all women 20 or older were in the civilian labor market, an increase of 0.8 of a percentage point over 1980. Meanwhile, the labor force participation rates of adult men continued their long-term downward trend.

The ratio of civilian employment to the total working-age population varied inversely with the unemployment rate. The number of employed rose from 58.3 percent of the noninstitutional population in December 1980 to 58.8 percent in May 1981, but fell to 57.5 percent in December. Although this percentage was less than the last peak of 59.3 percent, reached in the fourth quarter of 1979, it exceeded the previous 1973 peak (Chart 8–2).

Chart 8-2

Employment Ratio and Unemployment Rate



[1] EMPLOYMENT AS PERCENT OF NONINSTITUTIONAL POPULATION.
[2] UNEMPLOYMENT AS PERCENT OF CIVILIAN LABOR FORCE.

NOTE.—DATA RELATE TO PERSONS 16 YEARS OF AGE AND OVER; SEASONALLY ADJUSTED QUARTERLY AVERAGES.

SOURCE: DEPARTMENT OF LABOR.

WAGES, PRICES, AND PRODUCTIVITY

Wage increases showed moderation in 1981. As indicated in Table 8-4, the average hourly earnings index, compensation per hour, and wages set in larger collective bargains slowed significantly, while the employment cost index increased at about the same rate as in 1980.

TABLE 8-4.—*Measures of compensation, 1978-81*

[Percent change, fourth quarter to fourth quarter, except as noted]

Measure	1978	1979	1980	1981[1]
Employment cost index[2]	7.7	8.7	9.0	[3]9.1
Union	8.0	9.0	10.9	[3]9.9
Nonunion	7.6	8.5	8.0	[3]8.8
Average hourly earnings index[4]	8.4	8.0	9.6	8.3
Compensation per hour[5]	9.0	9.9	10.2	9.3
Wage changes in large collective bargaining agreements (total effective adjustment)	8.2	9.1	9.9	9.1

[1] Preliminary.
[2] Data are for wages and salaries of all private nonfarm workers.
[3] Changes are from third quarter to third quarter.
[4] Data are not seasonally adjusted.
[5] Data are for private business sector, all employees.

Source: Department of Commerce (Bureau of Economic Analysis), Department of Labor (Bureau of Labor Statistics), and Council of Economic Advisers.

Labor productivity declined by 0.5 percent during 1981 (Table 8-5). This was the fourth successive year of little change in productivity. Chapter 5 has discussed various reasons for the disappointing trends in productivity over the last decade. In addition, during the last 3 years, total output growth has been low, which has also tended to depress productivity performance. The near-zero productivity result meant that unit labor costs, the largest single cost in production, had to increase roughly one-for-one with total compensation last year.

TABLE 8-5.—*Changes in productivity and unit labor costs, 1977-81*

[Percent change, fourth quarter to fourth quarter]

Item	1977	1978	1979	1980	1981[1]
Output per hour	2.1	−0.5	−0.6	0.2	−0.5
Unit labor costs	5.2	9.5	10.5	9.9	9.8

[1] Preliminary.

Note.—Data relate to private business sector, all employees.

Sources: Department of Labor (Bureau of Labor Statistics) and Council of Economic Advisers.

During a year in which unit labor costs rose by 9.8 percent, prices could not rise at a substantially lower rate without sharply squeezing profits. The GNP deflator rose by 8.6 percent during 1981, somewhat lower than the 9.8 percent increase experienced during 1980 (Table 8-6).

TABLE 8-6.—*Measures of price change, 1977-81*

[Percent change, fourth quarter to fourth quarter]

Item	1977	1978	1979	1980	1981[1]
Implicit price deflators:[2]					
Gross national product	6.1	8.5	8.1	9.8	8.6
Personal consumption expenditures	5.9	7.8	9.5	10.1	7.8
Private nonfarm business output	5.7	8.3	8.3	10.0	9.3
Consumer prices:					
CPI-U, X-1	6.2	7.8	10.6	10.8	8.8
CPI-U	6.6	9.0	12.7	12.6	9.6
Farm value of food	6.4	17.5	7.3	13.5	−5.2
Energy[3]	8.2	7.5	36.5	18.9	12.6
Home purchase and finance[4]	8.9	13.4	19.8	17.8	11.9
All other	6.1	7.5	8.0	9.8	9.2
Producer prices of finished goods	7.1	8.8	12.8	12.4	7.2
Food	7.7	11.1	7.6	8.3	1.8
Energy	11.0	7.4	56.9	29.2	15.2
All other	6.4	8.0	9.4	11.1	7.6

[1] Preliminary.
[2] Seasonally adjusted data.
[3] Includes only prices for direct consumer purchases of energy for the home and for motor vehicles.
[4] Consists of home purchase and financing, taxes, and insurance on owner-occupied homes.

Sources: Department of Agriculture, Department of Commerce (Bureau of Economic Analysis), and Department of Labor (Bureau of Labor Statistics).

The deflator for personal consumption expenditures rose only 7.8 percent last year, down significantly from the year before. Inflation, as measured by the consumer price index for urban workers (CPI–U), declined even more, from 12.6 percent during 1980 to 9.6 percent during 1981. The CPI–U is widely recognized as having an upward bias in a period of rising mortgage interest rates, due to its treatment of owner-occupied housing. Some of the components that are used to measure the cost of homeownership—finance, insurance, and taxes—jumped quite sharply during much of 1981. An alternative measure of consumer prices known as "CPI–U, X–1" more appropriately measures the consumer cost of owner-occupied homes. It advanced only 8.8 percent. In late 1981 the Bureau of Labor Statistics announced plans to incorporate this alternative method of measuring the rise or fall in homeowner costs into the index. As shown in Table 8–7, real compensation per hour, computed on the basis of either the deflator for personal consumption expenditures or the alternative CPI measure, rose in 1981 after declining for 2 straight years.

TABLE 8–7.—*Alternative measures of changes in real earnings per hour, 1979–81*

[Percent change, fourth quarter to fourth quarter]

Item	1979	1980	1981[1]
Average hourly earnings index:			
Deflated by:			
CPI–U	−4.2	−2.6	−1.1
CPI–U, X–1	−2.4	−1.1	−.5
Fixed-weight price index for personal consumption expenditures (PCE)	−2.1	−.9	.2
Compensation per hour:[2]			
Deflated by:			
CPI–U	−2.5	−2.1	−.2
CPI–U, X–1	−.7	−.6	.4
Fixed-weight price index for PCE	−.4	−.4	1.1

[1] Preliminary.
[2] Data are for the private nonfarm business sector, all employees.
Sources: Department of Commerce (Bureau of Economic Analysis) and Department of Labor (Bureau of Labor Statistics).

CREDIT MARKETS

During the first three quarters of 1981, total funds raised in U.S. credit markets rebounded from the depressed levels of a year earlier, when credit controls and the recession restrained borrowing. Nevertheless, borrowing by all private domestic nonfinancial sectors remained well below the pace reached in 1979. High interest rates discouraged borrowing for purchases of consumer durables and housing and resulted in a rate of household debt accumulation, although up from 1980, only about three quarters of that experienced in 1979. Borrowing by the nonfinancial business sector grew only modestly

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during the first three quarters of 1981. This sector relied heavily on short-term financing, as extremely high and rising long-term bond rates restrained net bond issues to only half the total of the previous year. As a result, bank loans to businesses and the volume of outstanding commercial paper surged.

Borrowing by State and local governments declined modestly in 1981, as growth of expenditures slowed relative to tax receipts. However, Federal Government borrowing was up from 1980, and at more than double the rate of 1979. Federal borrowing totaled $79.3 billion, of which approximately $55.6 billion was used to finance expenditures on goods and services or transfer payments, while the rest was used for relending. Federally guaranteed loans declined in 1981, but borrowing by federally sponsored enterprises grew by almost two-thirds. Overall Federal participation in the credit markets rose to approximately the level of the previous peak in 1976.

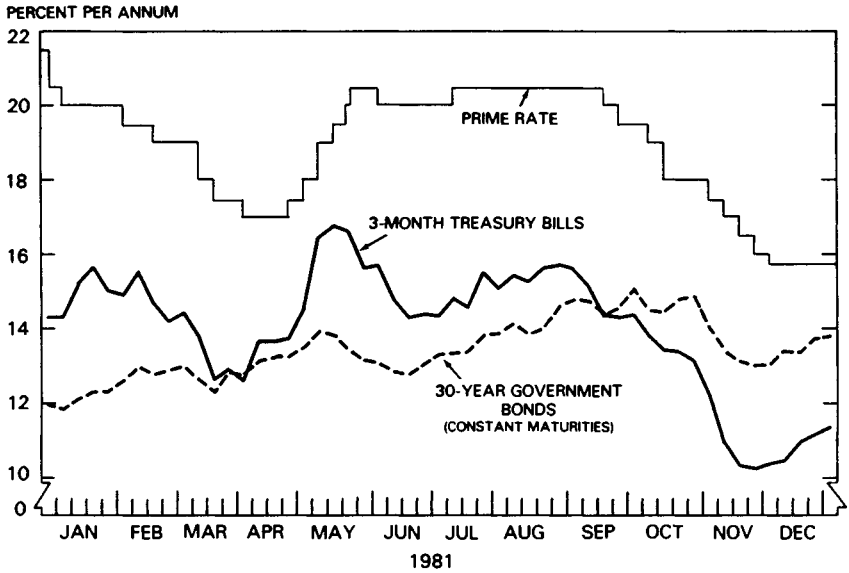
INTEREST RATES AND MONETARY DEVELOPMENTS

One of the four key elements of the Administration's program is support for a policy of continued gradual reductions in the rate of monetary growth to bring down inflation. This restraint was more important to the 1981 economy than other features of the Administration's program, which are aimed at encouraging long-term growth. From the fourth quarter of 1979 to the fourth quarter of 1980, M1 (currency plus checkable deposits) grew at a 7.3 percent annual rate. The Administration assumes a gradual but steady reduction in the growth of money to one-half that rate by 1986. After a period of adjustment, sustained declines in inflation and nominal interest rates are expected.

Federal Reserve policy in 1981 did produce a substantial reduction in monetary growth (as measured by M1) on a fourth-quarter to fourth-quarter basis—from 7.3 percent during 1980 to 4.9 percent in 1981. Nonetheless, interest rates remained high on average. The yield on 3-month Treasury bills, which had averaged 15.5 percent in December 1980, fell in early 1981, then rose again and peaked at 16.3 percent in May 1981. The prime rate charged by commercial banks declined from a peak of 21.5 percent in January 1981 to 17 percent in April 1981 before rising again to 20.5 percent by the end of May. By year-end, the prime rate had declined to 15.75 percent. Given that prices were advancing at somewhat less than double-digit rates, real short-term interest rates (that is, adjusted for inflation) were unusually high during most of 1981 (Chart 8–3).

Chart 8-3

Interest Rates in 1981



SOURCES: DEPARTMENT OF THE TREASURY AND BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM.

When allowance is made for the effects of taxes on interest rates, the high average level of short-term rates becomes more understandable. In an environment of high expected inflation, interest rates tend to rise sufficiently to compensate lenders for the anticipated loss in purchasing power of their money. Under the U.S. tax system, interest payments are deductible, and interest receipts are taxed as ordinary income. We would expect market interest rates to exceed a given real after-tax interest rate by more than the expected inflation. For example, if the real after-tax interest rate is 3 percent and the applicable income tax rate is 30 percent, an expected inflation rate of 10 percent would tend to produce a nominal interest rate of 19 percent—not very different from the peaks in short-term rates actually experienced in 1981. Viewed in this light, the question is not why short-term interest rates were so high in 1981, but why they were so low in the 1970s.

At least a partial answer to this question is that in the 1970s low State usury and Regulation Q ceilings prevented the effects of expected inflation from being fully reflected in interest rates, while the inflation that actually occurred was probably more than had been anticipated. Also, the oil price shocks of the 1970s, coupled with in-

creasing regulatory and tax burdens, may have reduced the expected real return on capital. With the change in the investment outlook brought about by the Administration's program, this negative influence on real interest rates began to disappear. However, as the Federal Reserve's program of bringing down the rate of monetary growth succeeds in reducing current and expected rates of inflation, nominal interest rates will fall somewhat more than the expected rate of inflation, even as real after-tax interest rates rise somewhat.

INTERNATIONAL CAPITAL FLOWS

High real returns on U.S. securities helped to attract foreign investment to the United States during 1981. The dollar's foreign exchange value rose 23 percent on a trade-weighted average basis from January through August before falling back slightly through December. Net foreign private purchases of U.S. securities during the first three quarters of 1981 totaled $8.3 billion, an increase of 68 percent over the same period a year earlier. A large part of this increase was in purchases of U.S. stocks, possibly suggesting confidence abroad in the medium-term potential of U.S. industry and the Administration's program.

Direct U.S. investment abroad in the first three quarters of 1981 slowed somewhat from its 1980 rate, making 1981 the second year of decline. The drop was due in part to sluggish foreign economic activity. In contrast, foreign direct investment in the United States remained strong during 1981 and may have approached the record levels of 1979.

Monetary flows associated with official transactions between the United States and other industrialized countries swung from a moderate net inflow in late 1980 to a substantial net outflow in the first three quarters of 1981. These net outflows primarily reflected sales of dollar-denominated assets by foreign central banks (mainly U.S. Treasury securities) related to intervention in foreign exchange markets. Changes in official U.S. reserve assets moved from net acquisitions of foreign currencies in late 1980 and the first quarter of 1981 to negligible acquisitions from the second quarter on. This reflected the decision by this Administration to adopt a policy of nonintervention in foreign exchange markets, except in conditions of severe disorder. (The issues involved in this policy are discussed in Chapter 7.)

Net capital flows between the United States and the Organization of Petroleum Exporting Countries (OPEC) recently have been quite stable relative to flows between the United States and the industrialized countries. The capital movements between the OPEC countries and the United States have been net inflows since early 1979 and generally have taken the form of investments in U.S. Treas-

ury securities, although investments in real estate and energy-related industries have risen during the past year.

THRIFT INSTITUTIONS

High interest rates and regulatory restrictions had an adverse effect on thrift institutions in 1981. From November 1980 to November 1981, the net worth of thrifts dropped over $5.7 billion, or approximately 13 percent. Net new deposits also declined.

In response to the plight of the thrift institutions, the Congress included in the Economic Recovery Tax Act a provision authorizing those institutions, as well as commercial banks, to issue All-Savers Certificates. The certificates were given tax-exempt status so as to provide thrifts and banks with a lower cost of funds. From October to December, the first 3 months of issuance, thrift institutions issued approximately $24 billion in certificates. Their impact on the net deposit inflows of the thrifts is in some doubt, however, since the availability of the certificates caused some savers to transfer funds from other thrift accounts, such as passbook savings, 6-month money-market certificates, and small savers' certificates.

Meanwhile, delinquent loans rose and liquidity ratios for insured savings and loans deteriorated. The delinquent loan ratio—the dollar amount of mortgage loans and contracts delinquent 60 days or more as a percentage of total mortgages and contracts held at the end of each month—increased steadily last year. The ratio rose from just over 1 percent in late 1980 to almost 1½ percent in late 1981. The liquidity ratio—cash and other liquid assets as a percent of savings deposits plus loans payable in a year or less—declined from almost 9 percent to about 8.5 percent in late 1981. The deterioration of these ratios was not surprising in light of historically high inflation and interest rates and the weakness of the economy in the past couple of years. The financial condition of thrift institutions can be expected to improve substantially, however, as inflation expectations and interest rates fall and financial asset prices rise.

PROSPECTS FOR 1982 AND 1983

The current recession is expected to end early in 1982, followed by a resumption of growth by mid-year. The moderating pattern of price increases which began last year should become more generalized and significant this year. With money growth expected to be moderate, the extent of the deceleration of inflation will become the critical factor in sustaining economic recovery beyond 1982. Apart from the very high rate of expected inflation reflected in current in-

terest rates, the economy is generally free of impediments to expansion.

The proportion of employed working-age adults will turn upward by this summer, reversing the general decline that began in 1979. Even at the expected low point of the employment ratio this spring, the proportion of people with jobs will be significantly higher than at the trough of all past recessions, except the very short 1980 contraction. The strong economic recovery this year and next is expected to expand civilian employment to over 103.5 million for 1983, well above the 98.8 million employed in 1979 before output declined.

The key areas of rebound in the economy this year are expected to be consumer goods, housing, autos, and defense (Table 8-8). The principal areas that are anticipated to lead the expansion next year are business investment, inventories (including a rising trend of defense work in progress), and a further acceleration in defense deliveries.

TABLE 8-8.—*Economic outlook for 1982*

Item	1981[1]	Forecast range 1982
Growth, fourth quarter to fourth quarter (percent):		
Real gross national product	0.7	3.0
Personal consumption expenditures	1.2	2½ to 3½
Nonresidential fixed investment	1.4	6½ to 7½
Residential investment	−21.9	24 to 27
Federal purchases	6.6	−2 to −1
State and local purchases	−2.0	−1½ to −½
GNP implicit price deflator	8.6	7 to 7½
Compensation per hour[2]	9.3	8 to 9
Output per hour[2]	−.5	1 to 1½
Level, fourth quarter:[3]		
Unemployment rate (percent)	8.3	8.4
Housing starts (millions of units)[4]	.9	1 to 1½

[1] Preliminary.
[2] Private business, all employees.
[3] Seasonally adjusted.
[4] Annual rates.

Sources: Department of Commerce (Bureau of Economic Analysis), Department of Labor (Bureau of Labor Statistics), and Council of Economic Advisers.

The decline in inflation, which has so far been most evident in the consumer price index and in producer prices, will influence trends in wages as 1982 progresses. But the expected 1 to 1½ percentage point slowdown of inflation in product prices will be only slightly less than the slowdown of labor costs. Therefore, the currently narrow margin of corporate profits is likely to recover only modestly during the year.

The unemployment rate is expected to reach the vicinity of 9 percent this spring until growth strengthens in the summer. Thereafter, the rapid pace of expansion should pull the unemployment rate down between one-quarter and one-half of a percentage point a quarter.

The growth in household consumption was restrained last year by high interest rates as well as by modest income growth. By the last quarter of 1981, consumption was approximately 1 percent higher in real terms than a year earlier, and new auto sales had fallen to an annual rate of 7.4 million. The decline in interest rates that began last fall, and improvements in household financial positions due to the reduced consumer debt burden and the first step of the personal tax cut, should lead to increased consumption early this year. The second step of the tax cut and the scheduled step-up in social security benefits will raise household disposable income roughly 2 percent this summer. It is difficult to predict how much of this increase will be allocated to saving or consumption. If between one-quarter and one-half of it is saved and the remainder is spent, the addition to the growth rate of consumption in the second half of this year would be about 3 percent at an annual rate. A large share of this would be expected to be used for the purchase of durables, whose annual growth rate in the second half is projected to approach 10 percent.

The recent improvement in early indicators of housing activity presages a rapid recovery that should be apparent by spring and proceed through the year. In 1980 the decline in housing early in the year was quickly reversed, and the ensuing recovery was quite rapid. Though the second reversal in the housing industry in as many years has forced some builders out of business, a rapid expansion this year is still possible. The necessary capital equipment remains, and additions to the stock of construction equipment and tools can be made rapidly. Though the supply of unsold homes relative to monthly sales is large, the absolute number of available new homes is not. Hence, rising sales will quickly generate faster building activity. While housing starts for 1982 as a whole may only exceed last year's by 10 percent, the increase during the year could exceed 50 percent. This would raise the pace of new housing starts from about 900,000 at an annual rate for the last quarter of 1981 to the vicinity of 1.5 million by the end of this year.

Business fixed investment has been maintained at a reasonably high level during the past year. The stimulus of the Accelerated Cost Recovery System depreciation package should make itself felt when recovery begins. Since businesses have not allowed inventories to build by large amounts, stepped-up sales this spring and summer will translate quite directly into rising output.

The Administration's program of strengthening U.S. defense capabilities will continue to be reflected in the overall economy as 1982 progresses. Deliveries of defense goods and services in real terms will

rise about 8½ percent during this fiscal year, about twice the increase in 1981. The rise in procurement of military hardware will be steeper. It will also generate stepped-up economic activity prior to deliveries. Defense industries are beginning to build up inventories of work in progress as components and materials move through the stages of fabrication toward delivery to the Department of Defense. Though this step-up has not yet become particularly evident in statistics of work in progress, this type of inventory accumulation will be strengthened in coming quarters.

Nondefense Federal purchases increased 10.7 percent in real terms during 1981 but may shrink as much as 9 percent during 1982 as the Administration's fiscal 1982 budget cuts take effect. The much larger volume of purchases by State and local governments is also expected to decline slightly in real terms. Taken in aggregate, the budgets of State and local units of government have shown small operating surpluses in the past 2 years. Increased revenue from economic growth is expected to more than offset declines in Federal grants, permitting a modest increase in nominal spending by State and local units.

Earlier parts of this *Report* have emphasized the relative size of the prospective Federal deficits in comparison to GNP. While it is helpful to standardize deficits against the size of the economy, this relation gives little feel for the distribution through the economy of the flow of government securities. These are purchased by banking, other corporate, household, and foreign savers, who are also filling their portfolios with privately issued notes for everything from consumer loans to mortgages to loans for business capital projects.

It is anticipated that each of these groups will not be called upon to raise their holdings of U.S. Government securities disproportionately. Thus, household purchases of U.S. securities should be about one-quarter of the volume of personal saving, which is near historic rates, and domestic financial institution purchases should be near 1.5 percent of GNP, also close to historic experience. While foreign investors also can be expected to take some of the securities issued, these two domestic sectors likely will account for most U.S. security purchases.

The net export balance of the United States is expected to be boosted by rising exports of goods and services as the economic recovery abroad strengthens but depressed by a large expansion of imports as growth picks up here later this year. Continued market adjustments to last year's appreciation of the dollar may also depress net exports. Depending on the timing of these effects, net exports of the United States may decline from a surplus of $23.8 billion last year to an approximate balance this year. Because the United States earns much more abroad through the export of services than it

spends on services imports, our net export position is stronger than the frequently cited trade balance on merchandise alone would suggest. That balance will move to a sizable negative position by year-end.

With a continuation of monetary restraint and further significant downward adjustments in inflationary expectations, 1982 and 1983 should become the first of several years of prosperous growth and declining inflation occurring simultaneously. While business investment and defense will continue to expand more rapidly than other sectors, the total growth in the economy should be sufficient to accommodate further sizable increases in the output of consumer durables, motor vehicles, and housing.

PROSPECTS BEYOND 1983

Continuing deceleration in money growth, fairly rapid adaptation of expectations to lower inflation, and growth aided by tax policies that are weighted toward investment are expected to be characteristic of the mid-1980s. The combination of growth-oriented fiscal policy and anti-inflationary monetary policy should mean substantial progress toward the economic goals embodied in the Full Employment and Balanced Growth Act of 1978.

The general objectives of this act—and those of the Administration—are to achieve full employment, growth in productivity, price stability, and a reduced share of governmental spending in the Nation's output. The act states clearly that ultimate price stability means eliminating inflation altogether. Although it does not define full employment as any specific unemployment rate, the act establishes as a national goal "the fulfillment of the right to full opportunities for useful paid employment at fair rates of compensation of all individuals able, willing, and seeking to work." It places emphasis on encouraging capital formation and relying on the private sector to meet the act's objectives of full employment, growth in productivity, and price stability. It requires an annual Investment Policy Report, which is provided in Chapters 4 and 5 of this volume. In addition, the act responds to the widespread desire for reduced governmental intervention by calling for steady reductions in the share of the Nation's output accounted for by governmental spending, and for the ultimate reduction of Federal outlays to 20 percent of GNP.

To provide a focus for the government in its effort to achieve these general objectives, the Full Employment and Balanced Growth Act requires that the Administration set annual numerical goals for key indicators over a 5-year horizon leading toward a group of interim goals set forth by the Congress. Table 8-9 responds to this require-

ment, based on the economic outlook for 1982 and 1983, and the longer term economic projections included in the fiscal 1983 budget. The act sets an interim goal for Federal outlays equal to 21 percent of GNP for 1981, and interim goals of a 4 percent unemployment rate and a 3 percent inflation rate for 1983. However, according to the act, the President may, if he deems it necessary, recommend modification of the timetable for achievement of the interim and final goals for unemployment, inflation, and Federal outlays as a share of GNP. The prior Administration extended the timetable for achieving all three goals beyond its 5-year planning horizon.

TABLE 8-9.—*Economic Projections, 1982-1987*

Item	1982	1983	1984	1985	1986	1987
	Level					
Employment (millions) [1]	100.9	103.8	106.2	108.6	110.9	113.0
Unemployment rate (percent)	8.9	7.9	7.1	6.4	5.8	5.3
Federal outlays as percent of GNP (fiscal year basis)	23.5	22.1	21.3	21.0	20.4	19.7
	Percent change, fourth quarter to fourth quarter					
Consumer prices	6.6	5.1	4.7	4.6	4.6	4.4
Real GNP	3.0	5.2	4.9	4.6	4.3	4.3
Real disposable income	4.3	4.1	2.7	4.6	4.0	4.0
Productivity [2]	.6	2.3	2.7	2.6	2.6	2.6

[1] Includes 1980 census benchmark.
[2] Real GNP per hour worked.

Source: Council of Economic Advisers.

Economic projections consistent with this Administration's policies indicate attainment of the interim and final goals for Federal outlays as a share of GNP within a 5-year horizon. The interim goal for Federal outlays as a share of GNP is expected to be met by 1985. The act's final goal of a 20 percent share of Federal outlays in GNP is anticipated to be achieved by 1987. Significant progress toward the interim goals for unemployment and inflation is also anticipated within this period. The economic expansion will reduce unemployment rates for significant subgroups of the labor force as well, including youth, women, minorities, handicapped persons, veterans, and middle-aged and older persons.

The Council emphasizes two points about the setting of a timetable for reaching these goals and about targeting economic performance in general. First, as has been emphasized elsewhere in this *Report,* the speedy adaptation of inflationary expectations to the anti-inflationary monetary regime set for the 1980s is of central importance in turning away from the rising inflation and unemployment of the last decade to an extended period of declining inflation with prosperous growth. However, as this *Report* points out—particularly

in Chapter 3—government efforts to intervene directly in wage and price setting in the private sector are essentially destabilizing and do not alter the longer term path of the economy. Second, the Federal Government cannot fully anticipate the course of the economy; neither can it direct economic outcomes precisely. In view of these limits, the annual goals should best be viewed as benchmarks of economic progress.