The Economy in 1981

In 1981 the nation made substantial progress in reversing the acceleration of inflation. In the process, however, production declined, and employment posted disappointingly small gains. The economy was expanding rapidly as the year began, continuing the rebound from the 1980 recession. But it began losing momentum as the year progressed, and was contracting sharply in the closing months of the year. On balance, real gross national product in the fourth quarter was only about ¾ percent higher than a year earlier. Thus 1981 extended the period of sluggish economic performance that began in 1979. Over this span, anti-inflation policy confronted the powerful upward momentum in prices, and as nominal GNP growth was constrained, little room was left for increases in real activity. By the end of 1981, however, mounting evidence suggested that the psychology that had contributed to the persistence of inflation was diminishing in intensity, and that higher unemployment and lower capacity utilization were at last forcing a moderation in wage- and price-setting decisions.

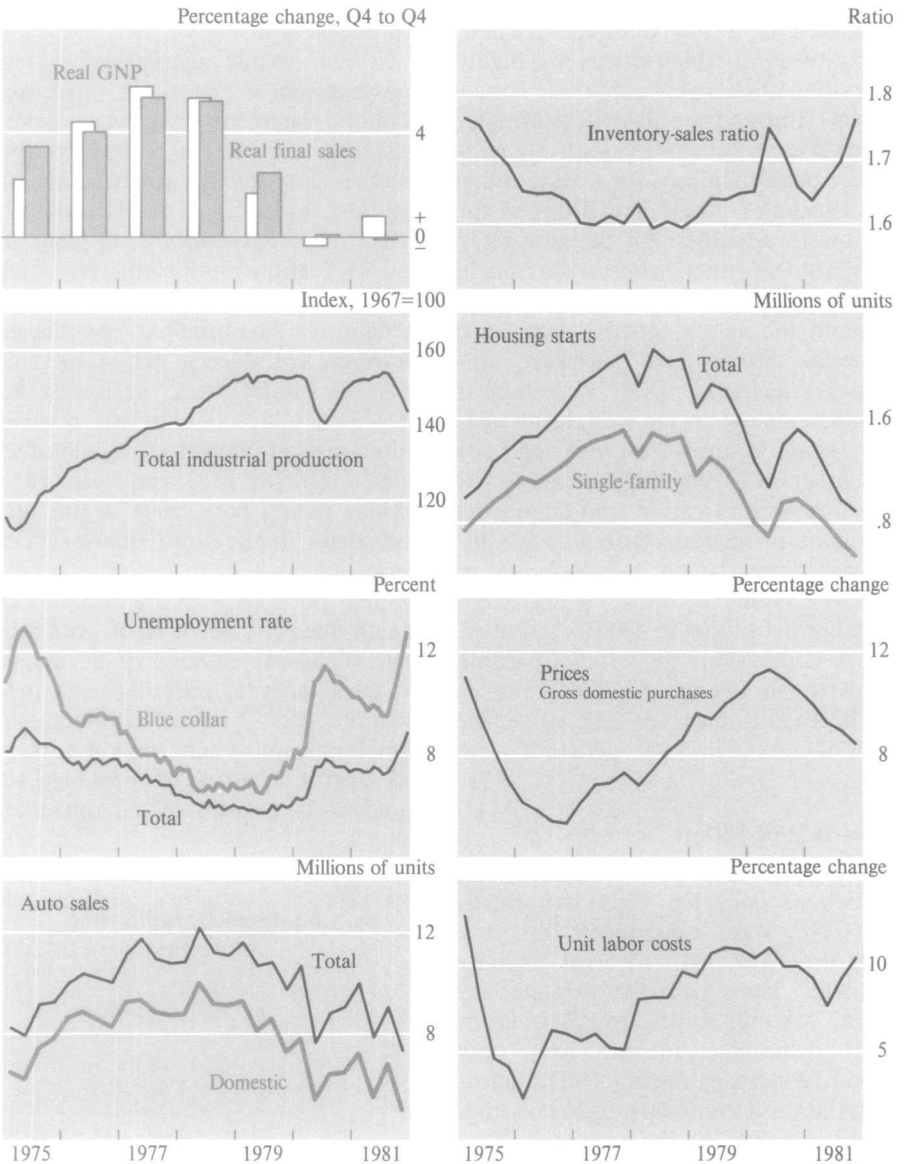
Sizable public and private demands for credit in 1981, occurring in an environment of monetary restraint, were reflected in unusually high interest rates. The high cost of financing exerted disproportionate strains on those sectors of the economy in which spending is heavily reliant on credit. Homebuilding, state and local construction, and consumer durable goods were comparatively weak in 1981. The only component of aggregate demand that grew rapidly was federal purchases of goods and services.

Industrial production rose slightly during the first half of 1981, but fell nearly 7 percent between July and December. Decreases were particularly large in the output of construction supplies and of consumer durable goods; in contrast, production of defense and space equipment continued to expand. The widespread declines in overall production caused capacity utilization rates for both manufacturing and materials to fall to about 73 percent by December, the lowest levels since 1975.

The continued sluggishness of economic growth limited the demand for labor, and job gains were meager in 1981. Nonfarm employment rose moderately through the first three quarters of 1981, but heavy job losses in the fourth quarter left payrolls at year-end only 150,000 higher than they were at the end of 1980. The trade and service sectors accounted for most of this increase; employment declined in manufacturing and construction, falling by December to levels below the 1980 trough. Over the year as a whole, the rise in total employment did not keep pace with the expansion of the labor force, even though the number of new job seekers rose much more slowly than during the 1970s. Consequently, the unemployment rate, after declining slightly through the first half of 1981, rose steadily through most of the second half and by December reached 8.8 percent, fractionally below its 1975 postwar high.

Inflation slowed noticeably in 1981.

Indicators of Economic Performance



All data are seasonally adjusted at annual rates. The industrial production index (monthly) is Federal Reserve data; the unemployment rate (monthly) and the change in unit labor costs are U.S. Department of Labor data; auto sales are from the Motor Vehicle Manufacturers' Association. All other data are from the U.S. Department of Commerce. Real GNP and real final sales are in terms of 1972 dollars. The inventory–sales ratio is based on real (1972 dollars) manufacturing and total trade sales and inventories. Prices are measured by the fixed-weight price index for gross domestic purchases (1972 weights); percentage change is from four quarters earlier. Unit labor costs are for the nonfarm business sector; percentage change is from four quarters earlier.

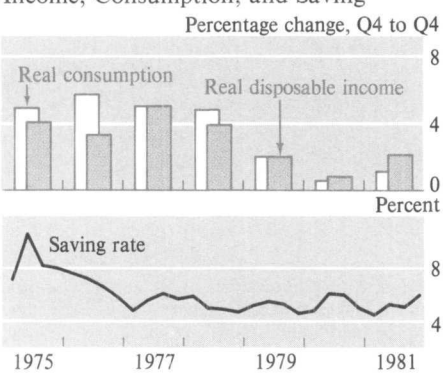
Early in the year, the signs of more moderate increases in prices were confined to a few markets, particularly those in which prices are highly sensitive to changing economic conditions. But as time passed, a broader deceleration became evident. By midyear, price increases for a wide range of consumer goods had dropped far below the double-digit pace of 1979 and 1980; further progress was made in the second half when price inflation in the capital goods sector also slowed. Surveys of consumer attitudes suggested that expectations about inflation in the near term were beginning to improve. With the pace of inflation slackening, inflation expectations moderating, and employers hesitant to increase hiring, wage increases also began to moderate in 1981. Nominal wage gains were smaller than those in 1980; moreover, wage concessions by workers became widespread toward year-end, and as 1982 began, the stage seemed set for a moderation in wage demands.

Household Sector

Personal consumption expenditures, which account for about two-thirds of GNP, were constrained last year by the weakness in real income growth. Even with the personal income tax cuts in the fourth quarter, real disposable income rose only about 2 percent during 1981, marking the third consecutive year of sluggish growth.[1] At the same time, the share of household budgets absorbed by basic necessities, such as food, energy, and other essential goods and services, continued to rise despite a marked deceleration in food and gasoline prices.

In real terms, aggregate personal consumption expenditures increased about 1 percent last year, even less than the rise in real disposable income. Households cut back spending on a wide range of discretionary items, such as furniture, appliances, and recreation equipment, but their cautious spending behavior was most evident in automobile purchases. Domestic producers last year sold only 6.2 million cars, the lowest figure in two decades. Cash rebates, below-market interest rates, and other sales incentive programs induced a brisker selling pace early in the year and again in the third quarter. But these increases were followed by extremely poor sales in the second and fourth quarters, when most programs were removed. In contrast to domestic sales, sales of imported cars held up quite well. About 2.3 million foreign cars were bought, only 4 percent less than in 1980; they accounted for a record 27 percent of the auto market.

Income, Consumption, and Saving



Based on U.S. Department of Commerce data, seasonally adjusted at annual rates. Real consumption and real disposable income are in terms of 1972 dollars.

1. Throughout the discussion of "The Economy in 1981," annual figures represent changes from the fourth quarter of 1980 to the fourth quarter of 1981 unless indicated otherwise.

Expenditures in real terms on residential construction fell 22 percent last year. By the fourth quarter, outlays were nearly 40 percent below the peak level in early 1978, making the downturn the longest in the postwar period and, by many measures, the most severe. Total housing starts averaged 1.1 million units in 1981. As interest rates for new mortgage commitments peaked at a new high in October, starts tumbled to an annual rate of 900,000 units during the final quarter. These annual and quarterly levels were the lowest since 1946. However, near the end of the year there were indications that activity and sales were stabilizing.

The decline in homebuilding activity was particularly sharp in the single-family sector, which accounts for around two-thirds of the housing market. Single-family starts fell around 45 percent to the lowest level on record, paralleling a sharp decline in home sales. During the autumn, sales of new homes were at their slowest pace since the beginning of data collection in 1963, and sales of existing homes set a 10-year low.

Construction in the multifamily sector declined about 33 percent in 1981 even though sustained demand for condominiums and cooperatives, typically offered at lower prices than detached homes, provided some support. But subsidized rental construction (under the section 8 program administered by the Department of Housing and Urban Development) fell to about half of its 1980 total. Building of nonsubsidized rental units also was quite weak in 1981 as high credit costs and longer-run uncertainties about profitability continued to depress this market.

The slowdown in real estate markets was reflected in a marked deceleration in home prices. The recorded average prices of new and existing homes sold during 1981 rose only 4 or 5 percent. For the first time since 1974, measured prices of existing homes sold were up less than overall prices. Moreover, the concessionary financing involved in many sales was not reflected by available price measures. Adjusting for the effects of such financing, average home prices may not have increased at all last year, and in some regions prices actually may have declined.

Business Sector

Business fixed investment adjusted for inflation increased 3 percent during 1981. Despite this gain, by the final quarter of the year, capital spending was still 2¾ percent below its peak in the third quarter of 1979. The weakness over the past two years can be traced in part to the stagnation in real final sales, which resulted in extensive and growing underutilization of capacity and a sharp decline in profits. In addition, the real cost of capital rose because of the upward trend in corporate bond rates.

Business purchases of equipment rose fractionally in real terms last year after a decline of almost 4 percent during 1980. Outlays for electrical machinery and transportation equipment, particularly cars and trucks, fell during 1981, while purchases of other equipment increased slightly. In contrast, spending on nonresidential structures, especially for commercial and industrial building and for petroleum drilling, continued to hold up relatively well, increasing 8¾ percent in real terms during the year.

Forward-looking indicators suggest that the weakness in capital spending

is likely to continue in 1982. Contracts and orders for plant and equipment in real terms declined throughout most of 1981; the fourth-quarter level was about 4 percent below that of a year earlier. In addition, surveys of spending plans suggested that capital outlays in real terms for calendar year 1982 would be little changed from 1981.

Responding to high carrying costs and weak sales, firms attempted to keep inventories on the lean side last year. Nonetheless, widespread involuntary accumulation occurred in the second half as the economy softened. Constant dollar inventory-to-sales ratios in most industries approached, and in some cases exceeded, the highs of 1975. Seeking to curtail excess stockbuilding, firms cut production substantially in the last four months of the year. The sizable liquidation of total manufacturing and trade inventories in December indicated that the adjustment of stocks to the reduced level of sales was under way.

Government Sector

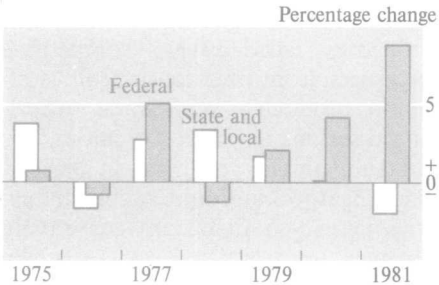
Total government purchases of goods and services in real terms rose 2 percent during 1981. However, advance in the total masks widely divergent movements between its two sectors. On the one hand, federal purchases increased rapidly; on the other, state and local spending fell, in marked departure from its past trend.

Federal tax receipts increased only 9¼ percent last year, about 2 percentage points less than during 1980 primarily as a consequence of the weakness in economic activity and provisions of the Economic Recovery Tax Act of 1981. Corporate tax accruals declined sharply because of the fall in profits and the new provisions for accelerated depreciation, and indirect business taxes rose at only one-third the pace of 1980. Growth of personal income tax receipts was curtailed by the 5 percent reduction in income tax withholdings in the fourth quarter. On the other hand, contributions for social insurance accelerated sharply, pushed by increases in both the tax rate and the tax base for social security.

Total federal government expenditures in nominal terms grew about 13½ percent last year compared with 19 percent in 1980. National defense purchases rose rapidly, as did outlays for the Strategic Petroleum Reserve and agricultural support programs. Spending for other nondefense programs was reduced. Net interest payments increased nearly 45 percent during 1981 primarily because of the high level of interest rates and the large deficits in fiscal years 1980 and 1981. Transfer payments grew less rapidly than during 1980, while grants to state and local governments decreased 9 percent over the year. With expenditures growing more rapidly than receipts in 1981, the deficit, as measured by the national income and product accounts, widened to about $100 billion at an annual rate in the final quarter.

Responding to the reductions in federal assistance, state and local governments curtailed their spending last year. In addition, growth of own-source revenues slowed as a result of lower profits-tax receipts and a smaller advance in personal taxes. State and local purchases of goods and services fell 2 percent in real terms; they had risen 3 percent per year on average during the 1970s. Payroll employment dropped substantially because of the termination of the federally funded public service

Real Government Purchases of Goods and Services



Based on U.S. Department of Commerce data, seasonally adjusted at annual rates. Real purchases are in terms of 1972 dollars. Percentage change is from fourth quarter to fourth quarter.

employment program under the Comprehensive Employment and Training Act. By year-end, most state governments had imposed hiring freezes. Construction spending, adjusted for inflation, fell to its lowest level in 25 years. In the last quarter of 1981 the sector's operating budget (total surplus excluding social insurance funds) recorded a small surplus.

Labor Market Developments

Continuing its rebound from the mid-1980 recession, employment expanded during the first three quarters of 1981. Most of the hiring was concentrated in services and trade. With demand subsiding and industrial activity slowing, employment growth in the goods-producing sector slackened and then began to turn down after midyear. In the final quarter of the year, declines in industry employment became widespread as businesses acted to bring production in line with sales. On balance, total nonfarm employment at the end of 1981 was just ¼ percent above the level one year earlier and only ¾ percent above the level at the end of 1979.

Employment in the goods-producing sector recovered a bit in late 1980 and early 1981, but not enough to make up the losses during the 1980 recession. Construction employment peaked in April at 150,000 below its 1980 high, and the 1981 peak for manufacturing jobs in July was more than one-half million below the level two years earlier. Factory employment started to edge off in August, and large cutbacks began in October. Layoffs in the cyclically sensitive durable goods industries accounted for about two-thirds of the decline in total employment in the fourth quarter; the metals, transportation equipment, and machinery industries suffered the largest losses. Employment in nondurable goods industries also fell, cutbacks continued at construction sites, and employment in retail trade turned down. From September to December, nonfarm employment fell almost 950,000.

Despite the gain in employment during the first three quarters of 1981, the unemployment rate receded only slightly from its year-end 1980 level of 7½ percent. Then, with the sharp rise in layoffs in the last four months of the year, the jobless rate jumped 1½ percentage points to 8.8 percent. The increase for adult men was particularly sharp because more of them are employed in the cyclically sensitive durable goods and construction industries; the unemployment rate for this group rose from 5.8 percent in July to a postwar record of 7.9 percent in December 1981.

In 1981, as in 1980, growth of the labor force fell far below its annual average of 2½ percent during the 1970s. In part, the slowdown reflected a shrinking teenage population. More fundamentally, the weakness in labor demand over the past two years apparently discouraged new

job seekers. The labor force participation rate for adult women, who had entered the work force in large numbers during the 1970s, edged up less than 1 percentage point in 1981; the rate for teenagers actually declined.

Because 1981 began with an economic recovery under way and ended during a contraction, growth in productivity showed considerable cyclical fluctuation over the year. Increases in output per hour in the first half were well above the trend rate of growth in recent years. But in the second half, productivity deteriorated as production dropped sharply and capacity use declined.

Wage demands were slow to respond to the erosion of employment opportunities over the course of 1981. Nevertheless, the trend of escalating labor costs showed clear indications of turning around. Wage rates for production and nonsupervisory workers posted increases of just over 8 percent in 1981, down from 9½ percent in 1980. And, after moving up in the beginning of the year, the rate of increase in white-collar earnings appeared to have leveled off by year-end. However, the moderation in wage gains in 1981 was partially offset by a substantial increase in the social security payroll tax, and total hourly compensation in the nonfarm business sector rose 9¼ percent over the four quarters of the year, down slightly from 10 percent in 1980.

New contracts under collective bargaining did not contribute directly to a slowing in wages during 1981, but the stage was set for a moderation in 1982 negotiations. Scheduled bargaining was light during 1981, and gains in union wages remained large relative to those received by nonunion workers, reflecting deferred increases and cost-of-living adjustments negotiated previously. However, union contracts were reopened in many industries during 1981. These industries faced severe competitive pressures from imports or from nonunion producers, and some experienced serious financial difficulties. As a result, unions and firms in the airline, meatpacking, and rubber industries agreed to significant cost-saving changes in negotiated contracts; by year-end, negotiators in the trucking and auto industries had begun to talk about similar departures from their traditional contracts, which are due to be renewed in 1982.

Prices

The trend in inflation improved noticeably during 1981, and by year-end all aggregate measures of inflation were well below double-digit rates for the first time since 1978. The fixed-weight price index for gross domestic purchases rose 8¼ percent over the four quarters of 1981, much less than in 1979 and 1980. This slowdown in inflation was even more pronounced in the consumer and producer price indexes, which had been rising at a 14 to 15 percent annual pace early in 1980: the consumer price index rose 9½ percent, and the producer price index for finished goods rose only 7¼ percent over the four quarters of 1981.

Retail food prices slowed markedly, to an increase of less than 5 percent during 1981, the smallest advance since 1976. Good growing weather in 1981 helped to push farm prices for crops 15 percent below year-earlier levels, and prices for meats and livestock also declined. Although supply developments in agriculture were much more favorable than in 1980, a part of the price slowdown was also

related to the general weakening of the economy. Slow growth of income restrained demand in domestic markets, while foreign customers reacted to sharply higher U.S. prices in the wake of a net appreciation of 16 percent in the trade-weighted exchange value of the dollar during 1981.

Energy prices rose sharply in the opening months of 1981 after further price increases by the Organization of Petroleum Exporting Countries and the President's decontrol of prices in domestic petroleum markets. At the same time, the war between Iran and Iraq curtailed supplies in the international oil market. However, by the summer a substantial decline in demand led to price stability for petroleum products. In contrast, the price of natural gas rose steadily throughout 1981 for the third consecutive year, as allowed under the decontrol schedule of the 1978 Natural Gas Policy Act.

In areas other than food and energy, signs also accumulated during 1981 that slack demand, and in part the rapid appreciation of the dollar, were reducing the rate of price increase. Prices for consumer commodities other than food, energy, and houses rose 8 percent in 1981, compared with 9¼ percent in 1980, and prices for capital equipment slowed markedly, from a 12 percent advance in 1980 to 9¼ percent last year. However, price pressures persisted in consumer services, notably for medical care.

The inflationary psychology that had permeated many aspects of economic behavior during the previous half decade appeared to be subsiding in 1981. Surveys by the Survey Research Center of the University of Michigan indicated a downturn in expectations of inflation over the near term. Furthermore, prices of sensitive industrial commodities and precious metals drifted down throughout 1981 after a decade marked by repeated speculative bursts. Finally, the behavior of real estate prices began to reflect the severe declines in home sales, after several years of rapid increases that were fueled in part by speculative pressures.