prepared to recommend additional policy measures if worsening economic conditions warrant such action.

THE ECONOMY IN 1980 AND 1981

The expected recession is likely to be mild and brief. Declines in real gross national product (GNP) should not extend much past midyear, and economic growth will resume later this year, albeit slowly at first. Over the 4 quarters of 1980 real GNP is forecast to decline by 1 percent.

Employment should remain almost unchanged despite the fall in real GNP, as productivity declines and the average length of the workweek is reduced. However, because job opportunities will not grow as fast as the labor force, the unemployment rate is likely to rise from 5.9 percent in the fourth quarter of 1979 to 7½ percent in the fourth quarter of this year.

In 1980 a major task of economic policy is to prevent the large energy shocks of 1979 from spilling over into wages and industrial prices. Greater slack in the economy will help to hold down inflation by discouraging large wage increases and creating resistance to price increases. The rate of increase in home financing costs should slow this year. Energy prices will continue to rise substantially, although most probably at a slower pace than in 1979. Over the 12 months of this year consumer prices are forecast to increase 10.4 percent, compared with 13.3 percent in the year just ended. Late in 1980 the annual rate of inflation should be between 9 and 9½ percent.

While several factors will be working to reduce inflation, dramatic progress cannot be expected because the momentum of past inflation is substantial and expectations of inflation are deeply entrenched. The pay and price standards will continue to help restrain the growth of wages and nonenergy prices, but they cannot be expected to yield a large reduction in inflation. Indeed, to the extent that workers seek and achieve larger nominal wage gains, some increase in the underlying rate of inflation—that is, the rate determined by the long-term trend in industrial costs—could occur this year. The degree of spillover of last year's price increases into this year's wages will be limited, however, not only by greater economic slack, but also by continuation of the voluntary pay and price standards.

Real growth is forecast to increase to a rate of 2¾ percent over the 4 quarters of 1981. Employment growth is also expected to strengthen, and consequently the unemployment rate is forecast to be slightly lower by year's end. Inflation should decline somewhat further, to about 8½ percent over the 12 months of 1981, as a result of some improvement in productivity growth and continued slack in labor and product markets.

FISCAL POLICY

Fiscal policy must continue to follow a course consistent with reducing inflation. This principle is particularly important in light of the large rise in oil prices in 1979 and the possibility of spillover from higher oil prices into wages and nonenergy costs.

In fiscal 1980 Federal outlays are projected to be $563.6 billion, an increase of about 14 percent from the previous year. In fiscal 1981 the budget projects outlays of $615.8 billion, a rise of 9 percent. Most of the increase in Federal outlays over the 2 years arises from the effects of inflation on the Federal budget. Adjusted for inflation, Federal spending will increase only about 2½ percent over the 2 years. Outlays for defense, in real terms, will rise somewhat more than 5 percent between fiscal 1979 and fiscal 1981. Inflation-adjusted outlays for all other Federal programs will be less in fiscal 1981 than they were in fiscal 1980.

Fighting inflation continues to be the top priority of economic policy, and hence the President has not recommended any legislated changes in tax rates in the 1981 budget. Since individuals will be moving into higher tax brackets as their incomes increase, the share of personal income taken by Federal income taxes will rise. Social security tax liabilities are scheduled to increase in January 1981 by $18 billion. The resulting rise in effective tax rates, combined with limited growth of Federal outlays, will cause the Federal budget to move significantly toward restraint in the next fiscal year.

MONETARY POLICY

The actions taken by the Federal Reserve on October 6 to restrain the growth of money and credit were followed by a sharp rise in interest rates to record postwar levels in the last quarter of 1979. Short-term market interest rates reached a peak in the third week of October but eased somewhat thereafter.

The changed approach to monetary control, with more emphasis on controlling the growth of bank reserves and greater willingness to permit fluctuations in interest rates, will help the Federal Reserve to hit its target ranges for the growth of the monetary aggregates. Short-term shifts in the demand for money and credit now show up in movements of short-term interest rates more than in the growth of the monetary aggregates.

While the new strategy will lead to more variation in the course of interest rates over the short run, it need not alter their central tendency. This will continue to be determined by longer-term trends in inflation and the demands for credit and money relative to the available supplies, which are influenced by the objectives of the Federal Reserve. As the year progresses, slowing economic activity and declining inflation should make the Federal Reserve's objectives for monetary restraint consistent with lower interest rates. The decline in interest rates that develops, however, is likely to be moderate compared to past periods of recession because of the persistence of a high rate of inflation.

WORLD OIL MARKETS

World oil markets are expected to be in a delicate balance in 1980. Although consumer demand for petroleum products has fallen and can be expected to decline further, continued high levels of stockbuilding, combined with supply cutbacks by some foreign producers, may offset whatever tendency might exist for the creation of slack in the international oil market.

The outlook presented here takes into account the most recent price increases announced by the Organization of Petroleum Exporting Countries (OPEC). In Caracas, the OPEC members did not agree on an integrated cartel pricing structure, though some member countries made an effort to narrow existing price differentials within the cartel. Since then some of the countries with the highest prices have posted additional increases. In early January the world price of oil was near $28 per barrel, more than twice its level a year earlier. The forecast makes allowance for the possibility that further increases in world oil prices may somewhat exceed the inflation rate during 1981.

THE ECONOMIC FORECAST

At this time the economy appears likely to head into a mild recession. Housing starts began to turn down in the fourth quarter of last year. New car sales also fell, and auto companies have curtailed their production schedules for the first quarter of this year to reduce abnormally large inventories, especially of large models.

The downward pressure on consumers' real incomes, resulting from rising oil prices and increasing fiscal restraint, is continuing. In the 2 years beginning with the final quarter of 1978, the high-employment budget will swing to surplus by $34 billion. Increases in crude oil prices, and in domestic oil refiners' and distributors' gross margins, in excess of the general rate of inflation will increase the revenues of domestic and foreign producers by $100 billion during these years. Some of these receipts will be respent within this time, but a large part will be retained. Allowing for such respending, and adjusting for double-counting, the combination of oil and fiscal restraint is estimated to rise by almost $80 billion over the 2 years ending in the fourth quarter of 1980, about 3 percent of GNP (see Table 12).

TABLE 12.—*Fiscal and oil price restraint on the economy, fourth quarter 1978 to fourth quarter 1980*

[Billions of dollars, annual rate]

Item	1978 IV to 1979 IV	1979 IV to 1980 IV	1978 IV to 1980 IV
Fiscal restraint [1]	20	14	34
Oil price restraint [2] less adjustment for double-counting [3]	42	3	45
Total	62	17	79

[1] Change in the high-employment budget.
[2] Increase in foreign and domestic producer revenues due to real increases in crude oil prices and refiners' and distributors' gross margins, less the estimated respending by oil sellers of their additional revenues. The 1980 estimates assume no further rise in real imported oil prices from levels prevailing early in 1980.
[3] Higher windfall profits taxes and corporate profits taxes due to real increases in crude oil prices and refiners' and distributors' gross margins, which are included in both the measure of fiscal restraint and the measure of oil price restraint, have been deleted from the latter.

Source: Council of Economic Advisers.

Around the middle of 1980, forces of recovery from recession are expected to be evident. Reduced restraint in financial markets will permit housing starts to turn up in response to strong underlying demand. As inflation abates, some of the drain on consumer purchasing power will be relieved. Continuation of fiscal restraint, together with maintenance of cautious inventory policies by businesses, will result in a slower pace of recovery than has been typical after earlier postwar recessions. The rate of economic growth is expected to strengthen during 1981, however, as businesses step up their capital spending plans. Table 13 reports the forecast for this year.

Consumer Expenditures

Consumer spending in 1980 will be restrained by the drain on consumers' purchasing power imposed by rising energy prices and the increases in effective tax rates caused by inflation. The rise in energy prices is expected to be smaller than in 1979, and there is likely to be some step-up in the rise of wage rates during 1980. But since employment is projected to change little this year, after-tax income in real terms will show only a small gain. An increase in tax refunds because of overwithholding of individual income taxes in 1979 will help to sustain the rise of after-tax incomes.

Last year the personal saving rate declined considerably and ended the year below 3½ percent. Some increase from this exceptionally low level seems very likely this year, but it should be small as people try to maintain their living standards in the face of slow growth of income. The expected rise in the saving rate, together with sluggish income growth, is expected to result in a decline in real consumer purchases of goods and services of between one-half and 1 percent over the 4 quarters of 1980. This would be the first reduction since 1974.

TABLE 13.—*Economic outlook for 1980*

Item	1979 [1]	Forecast range 1980
Growth, fourth quarter to fourth quarter (percent):		
Real gross national product	0.8	−¾ to −1¼
Personal consumption expenditures	1.6	−½ to −1
Nonresidential fixed investment	1.7	0 to −½
Residential investment	−8.3	−11 to −12
Federal purchases	1.1	3 to 3½
State and local purchases	−.4	−1¼ to −1¾
GNP implicit price deflator	9.0	8¾ to 9¼
Compensation per hour [2]	8.9	9½ to 10
Output per hour [2]	−2.0	−¼ to −¾
Level, fourth quarter: [3]		
Unemployment rate (percent)	5.9	7¼ to 7¾
Housing starts (millions of units) [4]	1.6	1½ to 1¾

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

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

Expenditures for consumer durable goods will be most affected. Automobile sales for the year will be below 1979 average levels but should improve in the second half. Purchases of other household durables may also decline, given the downturn forecast for housing starts.

Expenditures by consumers on nondurable goods are also expected to decline in real terms in 1980; purchases of energy-related items are likely to be cut considerably. Consumption of services will probably continue to rise but at a slower pace than in 1979.

Growth in real consumer spending should resume late this year and strengthen in 1981, when employment is expected to rise more strongly while inflation moderates. The increase in social security taxes scheduled for January 1, 1981, however, will limit the rise in real disposable income. In part for this reason, real consumption expenditures are likely to grow less rapidly than real GNP next year.

Business Fixed Investment

Current indicators suggest that business fixed capital spending in real terms should turn down moderately in 1980. New orders for nondefense capital goods, adjusted for inflation, have fallen from their peaks of last spring. Capital appropriations of manufacturing firms, adjusted for inflation, have also declined since the first quarter of last year. The most recent Department of Commerce survey of capital spending plans by business suggests that companies are planning to increase their real outlays by only about 1 to 2 percent on a year-over-year basis in 1980.

Business spending plans tend to be revised down when the economy weakens. With a mild recession early this year, capacity utilization will be falling, profits will be squeezed, corporate cash flow will diminish, and business spending will slow further. Recovery from the recession will lead to a strengthening of business investment plans early in 1981, and increased activity in this key sector will provide increasing support to economic growth next year.

Housing

The outlook for housing is more uncertain in 1980 than in the past several years. Late in the fourth quarter the severe strains evident in the mortgage market soon after the October 6 tightening of monetary policy were eased somewhat. Mortgage lenders appeared to be relaxing their lending terms a little; in some sections of the country mortgage loan rates were lowered from the extreme highs of a few weeks earlier. Interest rates on short-term market securities were down from their October peaks, and depository institutions gained additional power to attract funds for lending when the regulatory authorities, effective January 1, instituted a floating interest rate ceiling on deposits with a maturity of 2½ years or more.

These developments should help to improve the flow of mortgage credit early next year. Moreover the preemption of State usury ceilings by Federal law through March 31, which applies to new residential mortgage commitments made during the period as well as to residential loans closed, could lead to a substantial increase in credit available to potential home buyers in almost 20 States.

Very high mortgage interest rates will continue to discourage some individuals, however, and make it difficult for others to qualify for loans. It may also take time for builders to reassess the prospects for housing sales. A sample survey in mid-November conducted by the Bureau of the Census indicated sharp cutbacks in builders' construction plans for early this year.

Housing starts may therefore fall somewhat further to a trough before midyear. Single-family housing starts will bear the brunt of the decline. Unlike the 1974–75 experience, starts of multiple-family dwellings are expected to decline relatively little; vacancy rates are low, and demand is strong in this segment of the housing market.

Later this year housing construction should recover as demand responds to lower mortgage interest rates and continuing strong demographic factors. The favorable after-tax rate of return on housing compared with other physical and financial assets will also reinforce housing demand.

Some slowing in the rise of housing prices may occur in 1980, particularly in the first half, when sales will be depressed by the high cost of mortgage credit. This slowdown of inflation in the housing sector may be temporary, however, since the forces underlying the demand for housing are strong.

In 1981 housing starts should continue to increase toward levels consistent with their long-term determinants. By the end of next year housing starts may be close to a 2-million annual rate.

Inventories

As final demand weakens in the first half of this year, the rate of inventory accumulation is expected to fall. Since the cautious inventory policies followed by businesses during the recovery have prevented a large buildup of undesired stocks, no significant decumulation is expected. By around midyear, adjustments of stocks to lower levels of demand should be largely complete. Resumption of growth of final demand, together with lower rates of interest, will encourage an upturn in the rate of inventory accumulation in 1981.

Government Purchases

Real Federal purchases are projected to increase by about 3 percent over the 4 quarters of 1980, led by growth in defense outlays, and will continue to rise moderately during calendar 1981.

State and local government purchases in real terms are expected to continue falling in 1980. Concern over the impact of the recession on tax revenues, combined with taxpayers' resistance to expenditures for new programs, will operate to hold down spending. In 1981, as economic growth resumes and tax revenues increase, State and local purchases should increase in real terms, though much more slowly than real GNP.

Employment and Unemployment

Employment is likely to be almost unchanged in 1980 despite the weakness of overall economic activity. Declining real GNP during the first half is expected to lead to a further reduction in output per hour worked and to a somewhat more rapid reduction in the average workweek than occurred in 1979. In 1981 employment growth should be stronger as growth in real output increases.

Growth in the labor force is expected to average about 1¾ percent a year over the next 2 years. Weak growth of job opportunities will keep the labor force from growing at the rates of recent years. Nevertheless the increase in the number of job seekers will be larger than the rise in employment during 1980, and the unemployment rate is forecast to rise to 7½ percent by the fourth quarter of 1980. A small decline in the unemployment rate, to about 7¼ percent, is expected by the end of 1981.

Foreign Sector

Economic growth abroad is likely to slow from 4 percent in 1979 to an average annual rate of about 2 percent in 1980 and 1981. For the 2 years taken together, growth abroad is expected to be stronger than in the United States. These developments will add moderately to real net exports of goods and services.

The contribution of net exports to real GNP growth this year and next, however, will be significantly less than during the previous 2 years. Imports are projected to decline in volume during the course of 1980 and to recover only moderately in 1981—reflecting the pattern of mild recession and recovery foreseen for the U.S. economy. But the growth of exports is not expected to continue at the strong pace that marked the last 2 years, not only because growth abroad is likely to slow but also because the boost to exports from the past depreciation of the dollar will largely have run its course.

The deficit on merchandise trade, which was about $28 billion in 1979, is expected to increase somewhat over the coming 2 years because the generally favorable developments in non-oil trade will not fully offset the large increase in the oil import bill from 1979 to 1981. Agricultural exports, which reached record levels in the second half of 1979, should remain on a high plateau in 1980. This estimate makes allowance for the recent decision to limit grain sales to the Soviet Union. A small decline in the volume of agricultural exports over the 4 quarters of 1980 will be nearly offset by a slight increase in export prices of farm commodities.

The widening deficit on merchandise trade should result in a small current account deficit in 1980 and again in 1981, even though moderate increases in net receipts on invisibles transactions are likely. These developments are not expected to affect the value of the dollar adversely in foreign exchange markets, since the U.S. current account position should be stronger than that of other major industrial countries.

UNCERTAINTIES IN THE OUTLOOK

As in 1979, a major threat to the outlook is that OPEC decisions about prices and production may lead to increases in world oil prices that go well beyond those announced recently. Such a development would, in the short run, add to the restraint on the economy exerted by oil prices, exacerbate inflation, and lead to lower economic growth and higher unemployment. As Chapter 4 indicates, the probability of large price increases for oil will be diminished if the major consuming countries join to reduce demand in world oil markets. Discussions toward this end are now proceeding in the International Energy Agency.

The new orientation of monetary policy poses additional uncertainties. If inflation does not decelerate as expected, interest rates may be under more upward pressure than is now foreseen. On the other hand, if the Federal Reserve's monetary targets are attained easily because money demand weakens more than expected, the Federal Reserve's strategy will permit market forces to lower interest rates considerably. The central bank's scope for maneuver will be determined in part by developments in monetary policy abroad and by a variety of forces influencing the value of the dollar in exchange markets.

The potential behavior of the personal saving rate further complicates the assessment of the course of the economy. The saving rate is forecast to rise moderately from its exceptionally low level at the end of 1979. Should it increase further, economic growth would be weaker than expected. As Chapter 1 indicates, past experience provides only limited guidance on how individuals may choose to allocate their disposable income between current consumption and saving under present circumstances.

Perhaps the most serious risk for the longer-term performance of the economy is the possibility of a large spillover of energy price increases into wages and then into industrial goods prices generally. If temporary bursts in energy prices became a relatively permanent feature of the underlying cost structure, the outlook for inflation during the years immediately ahead would worsen; and, as Chapter 3 points out, the costs of bringing inflation back down again would be increased. Maintenance of effective pay and price standards is essential to minimize this spillover.

CONTROLLING INFLATION

Even during the very sharp 1975 recession the underlying rate of inflation never fell below the neighborhood of 6 percent. In 1976 and 1977 inflation remained at about this level. But early in 1978 inflation began to accelerate, initially on account of a dramatic increase in food prices that resulted from limited supplies of meat and the effects of cold weather on fruit and vegetable production. In 1978 and 1979 adverse productivity developments acted to push up unit labor costs. And around the close of 1978, as the economy was operating near the limit of its capacity, excess demand added briefly to upward pressure on prices. But a dominant factor in the most recent worsening of inflation was the explosion of energy prices in 1979. In the consumer price index (CPI) energy prices in 1978 had risen by 8 percent, somewhat less than the overall rise for other consumer goods and services. During the 12 months of 1979, however, energy prices to consumers increased by 37.4 percent, directly adding about 2¼ percentage points to overall inflation.

Temporary excess demand or sharply rising food and energy prices would not affect inflation for more than a limited period if they did not become built into longer-term trend rates of increase in wages and other costs. However, as outside shocks drive up materials prices, businesses may seek to maintain profit margins by raising prices. The higher prices of finished goods may induce workers to try