WEEKLY OUTLOOK
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MISREADING THE ECONOMY

FOR WELL OVER A YEAR, most of us have been hearing one economist or another (including the author) predict that the economy of the United States was ripe for a recession. At the same time, hints were given about a slowing down of the inflation rate. However, neither became a reality.

Within the last year, the United States came close to experiencing a recession. A recession is defined by the government as two consecutive quarters of declining real Gross National Product (GNP). During the second quarter of 1979, the GNP actually did decline by about $8 billion, primarily because of the slump in domestic automobile sales following the large price increases in OPEC oil. The economy recovered rather well, however, and the GNP resumed its expansion.

Economists misread what consumers would do over an extended period of inflation. Expecting the rate of inflation to remain fairly high, consumers continued to spend most of their income (saving little, if any) and to borrow. Why should consumers do otherwise? Passbook savings were (and still are) earning negative real interest. An interest rate of 10 to 12 percent on borrowed money was low, considering inflation and the growth in real income.

Several significant events took place after the first of the year. First, Mr. Volcker, Chairman of the Federal Reserve Board, apparently felt that money was too easy to obtain. Therefore, he began bumping up the interest rate on the money banks can borrow from the Federal Reserve, which led to the current 20 percent prime rate large banks are changing their better commercial customers. Interest on consumer loans has now risen to the general range of 15 to 17 percent.

The second significant event was the changes in the Consumer Price Index (CPI), for January and February rising to near 20 percent on an annual basis. This, among other things, caused the third significant event to occur. President Carter announced that he would balance the government's budget for the 1981 fiscal year.

So where does the economy stand now? According to figures released last week, the unemployment rate rose to 6.2 percent in March, and the Wholesale Price Index was 1.4 percent during the same month (about 17 percent on an annual basis). The CPI is likely to continue at just under 20 percent for March and possibly April.

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Do a rising unemployment rate and a rapidly increasing CPI mean the United States will have a recession and uncontrollable inflation? Not likely. Unemployment is generally the result of a recession, not the cause. Also the rapid runup in the CPI over the last few months is primarily the result of large increases in interest rates, especially mortgage rates, and energy prices. Excluding these two items, the rise in the CPI would only be around 8 percent on an annual basis.

The following prospect for the economy is more likely to happen. Rising interest rates will take their toll on consumer borrowing and possibly business borrowing. If consumers have to pay more for less in terms of available money, they will cut spending on housing, automobiles, and many other items. Eventually, this reduction in consumer demand will cause the United States to begin its first recession since 1974-75. My guess is the second quarter of 1980. (Note that about two-thirds of the GNP comes from consumer expenditures.) Recessions usually slow down the rate of inflation. If this occurs and the recession is obvious, the Federal Reserve probably would begin to lower interest rates in August or September. That would slow inflation a bit more and make more money available for consumers to spend. Doing so will help bring the economy out of the recession late in the year. In short, expect a recession of 2 to 3 quarters during the last part of 1980, while inflation moderates to 10 to 12 percent on an annual basis.

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