Research Department
Federal Reserve
Bank of
San Francisco

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FRB SF Weekly Letter

Consumers and the Recession

As recent headlines told us, the U.S. economy fell deeply into recession during the second quarter, with a 9.1-percent annual rate of decline in real GNP. That decline was the sharpest one of the past generation, except for the equally sharp decline of first-quarter 1975. Who was responsible for this performance? Appropriately, it was the consumer—who was also largely responsible for the strong and prolonged expansion of the late 1970's.

The current recession may turn out to be unusual, because of the possibility that the downturn will be concentrated in its initial quarter. (In fact, the Congressional Budget Office estimates that that quarter will account for two-thirds of the recession's cumulative downturn.) In contrast, in four of six previous recessions, the most severe quarterly decline occurred in the *final* quarter. However, this recession is not yet over, and its final shape will depend greatly on what the consumer does from now on.

1975 vs. 1980

The shift in the consumer's role can be seen from a comparison of the contributors to the real-GNP declines of first-quarter 1975 and second-quarter 1980 (see chart). In the earlier period, the inventory sector dominated the decline. Inventories had gotten far out of line in a period of weakening demand, because business firms—responding to sharp price increases of raw materials—boosted their purchases of supplies in anticipation of further price increases. As a consequence, these firms were forced to reduce their inventories severely in the early part of 1975. But for most other GNP components, the recession already was almost over. Consumption spending had already turned positive, and residential consumption had almost bottomed out—although business capital spending still had several quarters of decline ahead.

In second-quarter 1980, in contrast, consumer spending accounted for two-thirds of the entire decline in total output—whereas inventory spending actually increased somewhat as an unwanted consequence of the drop in consumer spending. The drop in consumer purchases was concentrated in durable goods—especially autos, which registered their lowest selling rate in more than two decades. But the household spending decline was also reflected in a one-fifth reduction of residential construction spending from the previous quarter.

The economy actually had been declining since January, according to the chronology of the semi-official National Bureau of Economic Research. Employment, retail sales, and industrial production all began to decline during the winter quarter, reflecting the distortions caused by the upsurge of energy and other prices.

Sources of weakness

The second quarter was notable, however, for marking the culmination of an unprecedented rise in interest rates, whose effects were keenly felt throughout the household sector. Housing probably suffered most as mortgage rates soared to the range of 16 to 18 percent, at which point home construction and sales skidded to a halt. Auto sales also reflected the high cost of credit, both for household purchases and dealers' flooring loans, which were linked to a prime business-loan rate which peaked at 20 percent during this period.

Consumer spending also reacted to the severe inflation, seen most obviously in the 110-percent increase in OPEC oil prices in 1979 and early 1980. The impact spread well beyond autos and gasoline. As fuel costs climbed, transportation fares rose accordingly. In response, non-commercial travel dropped by 10 to 20 percent, and hotel-motel and related leisure services suffered in similar fashion.

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But in many respects, the consumer caution of mid-1980 was a response to an earlier spending pace which continually outpaced income. During 1979, for example, real consumption increased only 1.6 percent, but that was three times that year's increase in real income. (Most of the consumption increase occurred in the second half, when income gains were very weak.) Consumers financed this spending/income gap partly by increasing external financing, raising the ratio of instalment credit extensions to a record 20.3 percent of after-tax income. Consumers also sharply reduced their rate of saving out of after-tax income, bringing it down from 5.4 percent to 3.5 percent in the second half of the year.

Consumers sharply increased their borrowing in 1979, either through instalment-debt extensions or through inflation-enhanced equity in homes. Consumer credit outstanding increased almost 15 percent over the previous year's level. Meanwhile, home-equity loans ran as high as an estimated $100 billion in 1979, or more than 6 percent of after-tax income.

Debt and savings

All that changed by the second quarter of 1980, however, as consumers sharply reduced their new debt-to-income ratio to 14.6 percent—almost six percentage points below the year-ago figure. They were encouraged to cut back by the Federal Reserve's credit-restraint program, which was imposed in mid-March to dampen the speculative buying that had affected many financial markets in the early part of the year. The program did not apply to the already weakened auto and housing markets, but it affected credit-card and similar purchases as lenders took this opportunity to tighten credit terms much more than they had previously been willing to do. Before being removed in early July, the controls—along with the recession—helped bring about an almost unprecedented second-quarter decline of $9.0 billion in outstanding credit.

In a parallel move, consumers increased their savings rate during the second quarter—savings, the residual, automatically increased as debt-supported spending declined. Whether willingly or not, consumers began to repair their balance sheets by reducing their new-debt assumption, thereby raising their savings rate. But the one-percent rise in the savings rate had the effect of reducing consumption spending by $17 billion below what it otherwise would have been.

Repeat past trends?

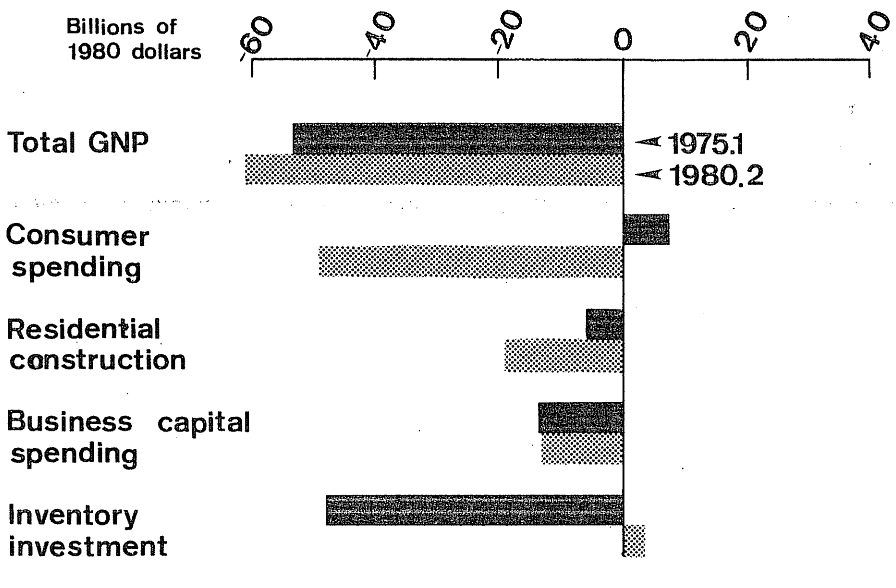
At this point, no one can foretell what role the consumer will play in creating and sustaining an eventual business upturn. Over the past quarter-century, the first year of cyclical recovery typically has been marked by a jump of 6.6 percent in real GNP. In that first robust year, consumers generally regain their lost confidence and begin buying again—and business firms respond by increasing their orders to fill out their depleted inventories, thus setting the stage for further increases in production and employment.

Most forecasters today, although assuming a turnaround by the end of the year or thereabouts, do not envision a full-scale recovery in 1981. The Congressional Budget Office recently projected real GNP growth within the range of 2½ to 4½ percent between the fourth quarter of 1980 and the fourth quarter of 1981, and the Office of Management and Budget came in with a forecast near the lower end of that range. But whatever happens, the consumer will play a crucial role in determining the strength of the upturn.

A few optimistic signs have already surfaced. Home-building activity increased sharply in June, although still lagging 37 percent behind the year-ago figure. Retail sales rose for the second straight month in July, with autos leading the advance, although auto sales totals were still the worst for any July of the last 18 years. But a great deal still depends on the near-term state of consumer income, consumer borrowing intentions, and above all, consumer psychology.

Herbert Runyon

SHARES OF REAL GNP DECLINE



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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 7/30/80	Change from 7/23/80	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	136,973	42	6,750	5.2
Loans (gross, adjusted) — total#	115,253	– 8	7,656	7.1
Commercial and industrial	33,240	– 4	1,423	4.5
Real estate	46,890	87	7,602	19.3
Loans to individuals	23,591	43	973	4.3
Securities loans	869	– 116	– 1,018	– 53.9
U.S. Treasury securities*	6,299	9	– 1,128	– 15.2
Other securities*	15,421	41	222	1.5
Demand deposits — total#	42,797	597	– 1,061	– 2.4
Demand deposits — adjusted	31,119	92	175	0.6
Savings deposits — total	28,925	55	– 1,641	– 5.4
Time deposits — total#	61,642	– 103	10,513	20.6
Individuals, part. & corp.	53,417	– 46	10,769	25.3
(Large negotiable CD's)	22,405	120	4,381	24.3

Weekly Averages of Daily Figures	Week ended 7/30/80	Week ended 7/23/80	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (–)	– 92	– 50	18
Borrowings	4	30	75
Net free reserves (+)/Net borrowed(–)	– 96	– 80	– 58

* Excludes trading account securities.
# Includes items not shown separately.

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