The Midwest and the recession

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For almost two years the economy has been stumbling on a rocky path marked by soaring inflation, record-high interest rates, and a constant specter of fuel shortages. During this period the Midwest, which includes the Seventh Federal Reserve District, has shouldered a disproportionate share of the trouble. Primarily, this reflects reduced demand for the products of some of the dominant industries in this region—cars and trucks, construction equipment, agricultural equipment, recreational vehicles, and home appliances. Residential construction also has been much more seriously depressed here than nationally, partly because of slower growth of population.

Some say that there has not been a recession anywhere *except* in the Midwest. This is an exaggeration. The sharp drop in general activity in the second quarter of 1980 was evident almost everywhere. Over the longer period the chronic problems of the motor industry have affected all regions to some degree. Finally, the impact of reduced availability of mortgage credit has dampened home building everywhere to some extent, even in the booming California market.

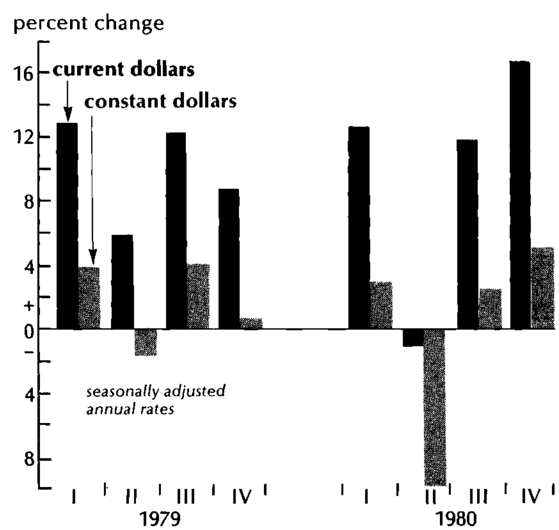
1980 reviewed

Since the spring of 1979, fears that the nation would slide into a deep and extended recession have been almost continuous. The common measure of the performance of the economy is the gross national product adjusted for inflation (real GNP). Perhaps never before has this measure performed as erratically.

Real GNP dipped at an annual rate of 2 percent in the second quarter of 1979, primarily because of oil stringencies resulting from the Iran shutoff. However, this decline was more than offset by a rise in the third quarter of that year, and modest gains continued into early 1980.

In March and April of 1980, severe credit restraint programs adopted by lenders followed the evocation of the Credit Control Act by the President and its implementation by the Federal Reserve. With the economy on an uneasy plateau, the effect of further abrupt tightening of credit was immediate. New orders were slashed in virtually all industries as managers tried to reduce inventories. New mortgage commitments dried up. In the second quarter of 1980, real GNP dropped at a 10 percent annual rate. The Federal Reserve's industrial production index dropped 8 percent from March to July, and payroll employment declined by 1.3 million.

In the late spring of 1980, many professional forecasters thought that the decline in activity would continue through 1980 and perhaps into the new year. However, as credit eased in the summer, most activities revived. Real GNP rose slowly in the third quarter and at an accelerated pace in the fourth quarter, but failed to regain the first-quarter high. From July to December industrial production



rose 7 percent, and payroll employment regained the March level, despite a lag in manufacturing employment.

For 1980 as a whole, real GNP just equaled 1979, after a 3 percent rise in 1979. In the last recession real GNP had declined 1 percent in two successive years, 1974 and 1975. Industrial production declined 3.6 percent last year, much less than the 9 percent drop in 1975. Payroll employment averaged 800,000 *higher* in 1980, compared with a 1.3 million *decline* in 1975. Housing starts at 1.3 million were down 36 percent from the recent cyclical high of 1978. From 1972 to 1975 housing starts had dropped by a half.

Inventories kept in line

Why did the economy right itself and start growing again after the one-quarter declines of 1979 and 1980? Historically, general business declines usually gather momentum and continue for two to four quarters. Large gains in personal income helped by government transfer payments, and rapid growth in other budget outlays provide part of the answer. Perhaps of greater importance was the fact that no classic inventory cycle developed. In each of the business recessions since World War II, the shift from inventory accumulation to liquidation played a major role.

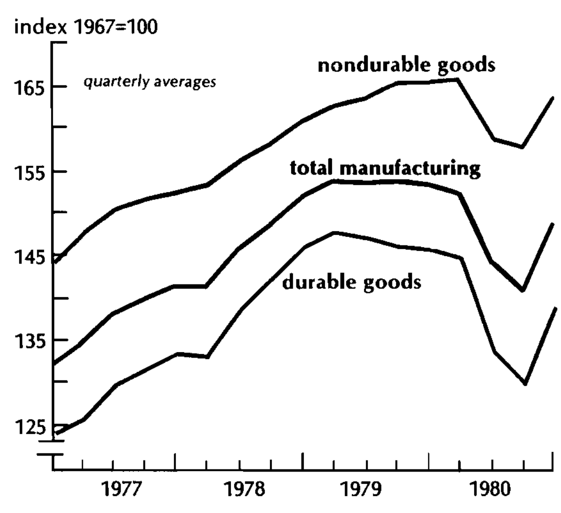
In 1979 and 1980 most business managers had kept inventories lean. Lead times on new orders remained short as "hand-to-mouth" buying was the rule. With final demand maintained at high levels, decisions to reduce stocks further were self-limiting, assuming businesses wanted to maintain satisfied customers.

In 1975 nonfarm inventories, adjusted for inflation, declined by $8 billion after a rise of $12 billion in 1974. The change from inventory accumulation to liquidation between these two years amounted to $20 billion and exceeded the $14 billion decline in real GNP. In contrast, inventories declined by less than $1 billion in 1980, following a rise of $8 billion in 1979. The impact on total output was only half as great as in 1975.

Business managers always try to keep inventories as low as is consistent with maximizing profits. Interest expense, along with rent, taxes, and insurance, is one of the reasons. In the 1950s and 1960s, when money could be borrowed at about 6 percent, interest cost was not a critical factor in inventory management for most firms. Interest is tax deductible, and the moderate inflation of those years meant that interest cost might be offset by appreciation in the value of the inventory. In 1979 and 1980 the prime rate was never under 11 percent and in some periods in 1980 exceeded 20 percent, levels undreamed of in earlier decades. Moreover, floating rates on bank loans meant that rates could be raised while items remained in stock. Such interest costs made it imperative to keep stocks at an irreducible minimum even at the risk of losing sales. Firms with surplus cash to invest also found it profitable to hold down inventories to increase short-term investments at high rates.

Another factor that kept inventories low during the expansion of 1975-80 was a desire not to repeat the experience of the last recession. In 1973-74 widespread shortages, aggravated by price controls on materials and components, caused many firms to lay in

Manufacturing output recovered in late 1980



extra supplies for precautionary reasons. The sharp drop in activity in the fourth quarter of 1974 led to widespread order cancellations with resultant production cutbacks and adverse effects on profits. No such rash of cancellations accompanied the short-lived recessions of 1979 and 1980.

Various industries, including steel, nonferrous metals, paperboard, motor vehicles, and household appliances, experienced one or more inventory cycles of their own in 1979-80. Cutbacks in output were limited by the need for distributors and retailers to restock after moderate liquidations.

Customers slow payments

In 1980 complaints by businesses, large and small, that collections on receivables had slowed were probably more frequent than at any time since the early 1930s. The Credit Research Foundation reported that outstanding receivables of manufacturers averaged 45 days' sales, and receivables of wholesalers averaged 43 days, up from 41 and 38 days, respectively, in 1977. Delinquencies and bad debts also increased. A slowing in collections tends to cumulate because payments often are dependent upon timely collection of receivables from others. In many cases past-due receivables reflected serious financial problems of companies whose very existence was threatened. More frequently, however, firms slowed payments wherever possible to avoid increasing borrowings at high rates. Other firms with large cash reserves held back on payments in order to increase earnings on short-term investments.

Some sellers of goods and services reacted to the tendency for customers to stretch out payments by refusing to ship, or render additional services, until payments were updated. Some resorted to COD (cash on delivery) shipments, requiring that truck drivers have certified checks in hand before unloading their vans. Credit investigations and criteria became more exacting.

Restraints on trade credit, like hand-to-mouth inventory buying, tend to hold down general business activity. However, such restraint also reduces the likelihood of a classic boom and bust resulting from unbridled credit expansion.

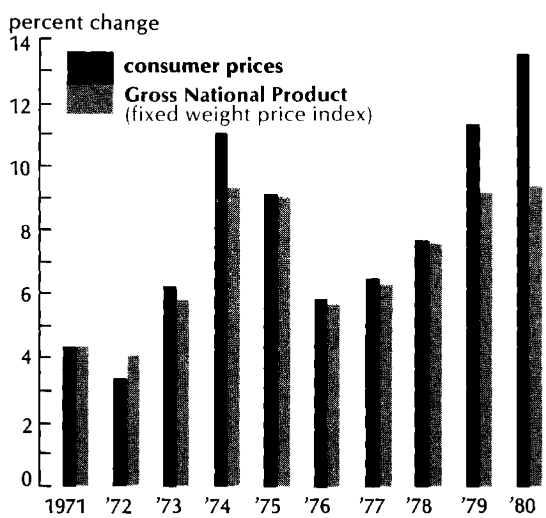
Capital spending trimmed

In the years 1977-79, business capital spending on new structures and equipment rose at an average of 17 percent annually, while nominal GNP rose at an average rate of 12 percent. In this period the ratio of capital spending to GNP rose from 10.1 percent to a record 11.6 percent. In 1980 GNP rose 9 percent, while capital spending rose 5 percent.

High interest rates, along with greater uncertainties regarding the future caused some firms to cut back on planned capital spending in 1980. This was true not only of small firms lacking access to the capital markets, but also of some hard-pressed large firms. Private rating agencies responded to poor financial results by reducing credit ratings, making it more difficult to sell debt on acceptable terms. Most large companies with adequate resources went ahead with expansion plans already under way, but many postponed approvals of new projects.

Corporate bond issues in the first half of 1980 were half again as large as a year earlier, but volume dropped in the second half as

Consumer price index has out-paced the general price level



interest rates rose sharply. New high-grade corporate bonds yielded about 9.5 percent in most of 1979, high by past standards but manageable. Last year the rate moved to the 13 percent range in the early spring, turned down in the summer, and then set new highs in the 14-15 percent range in December. Many corporate treasurers refused to sell bonds at these rates. A huge backlog of issues was said to be building up to be offered if rates dropped to 12 percent or less.

Nonresidential construction projects are commonly financed with mortgages purchased by insurance companies and other institutions. Commitments are usually made well in advance of actual construction. Thus, construction activity can continue at a high level for months after commitments have been cut back. Such a cutback occurred in the summer of 1980. Some insurance companies, worried about withdrawals of funds by policyholders, halted all commitments despite yields of 15 percent or more available on high-grade mortgages.

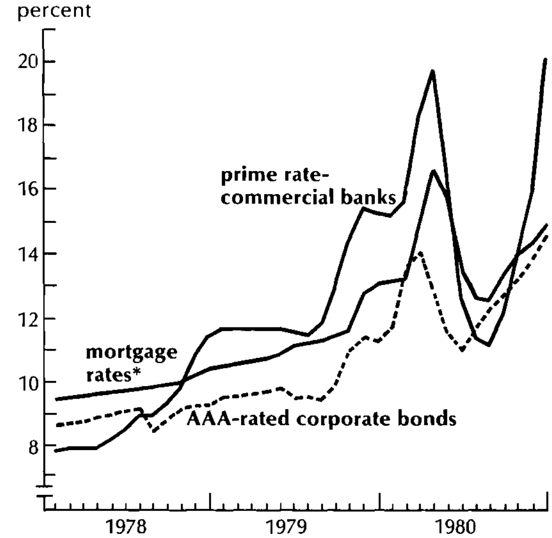
Much capital equipment is financed on instalment loans similar to consumer credit. Examples are construction equipment, agricultural equipment, heavy trucks, and trailers. The upsurge in interest rates in 1980 caused many dealers to reduce orders to manufacturers because of floor planning costs. Many buyers were deterred by heavy monthly payments necessitated by rates in the 18-20 percent range or failed to meet stricter credit criteria.

Autos and trucks nosedive

Sales of domestic autos dropped to 6.6 million in 1980, 30 percent below 1978, the best recent year and the lowest since 1961. Sales of imports at 2.4 million set a new high, but even the most popular imports were meeting sales resistance late in the year. Truck sales at 2.5 million, including a half million small imports, were 40 percent below the 1978 level.

Sales of cars were at a respectable annual rate of 11 million in the first quarter of 1980. But tight money and the recession brought an

Interest rates soared to record highs in 1980



*Effective commitment rates, 80% conventional loans.

abrupt decline in the second quarter and only an incomplete recovery in the second half.

Output of cars and trucks combined was only 8 million in 1980, 38 percent below the record 12.9 million total of 1978 and the lowest level since 1961. Production of steel, nonferrous metals, rubber, and glass intended for the auto industry declined even more than 38 percent because of the smaller average size of vehicles. In a related development, production of recreational vehicles in 1980 was 76 percent below 1978.

Employment in the motor vehicle industry dropped from over a million in early 1979 to 730,000 last May. Indefinite layoffs totaled 250,000 at one point last summer, and they remained at over 180,000 late in the year.

Tight credit depressed sales of autos and trucks in three ways. First, dealers' floor plan rates rose to unheard of levels of 22 percent, 24 percent, and more, causing them to order fewer vehicles and pushing many of them to the wall. Second, higher rates on consumer loans increased monthly payments for instalment buyers. Third, lenders became more selective in accepting risks, and some completely stopped making auto loans.

The troubles of the motor industry cannot be blamed entirely on tight money. Prices of vehicles have risen very sharply because of liberal labor contracts, higher materials prices, and costs of complying with government regulations. Meanwhile, the Japanese have been offering cars and trucks that many Americans have found to be more suitable than domestic products. Finally, soaring gasoline prices have reduced driving and cars are lasting longer.

Housing slumps

Last year construction was started on 1.3 million housing units nationally (860,000 homes and 450,000 apartments), down from 1.7 million in 1979 and 2 million in 1978. From 1978 to 1980 total starts dropped 34 percent, homes by 40 percent, and apartments by 23 percent. The decline for apartments was softened by increased federal funds for subsidized projects and by strong demand for condominiums in some areas.

The Midwest was affected much more than the nation by the housing slump. Data compiled by Bell Federal Savings for the Chicago area show that permits for new housing units totaled only 13,000 in 1980, down 74 percent from 50,000 in the best year, 1977, with homes off 82 percent and apartments off 59 percent. Reports from other large Midwest centers were almost as bad, and some smaller communities reported no activity at all.

Part of the Chicago area's problem is outmigration. The central city had been losing population in the 1950s and 1960s, but in the 1970s the population of the whole metropolitan area stabilized. Loss of population, in part, reflects loss of jobs. Nevertheless, the drop in housing construction would have been much less severe if credit had remained as available as before.

Conventional mortgage rates pierced the 10 percent level in 1978. Last spring, and again late in 1980, rates were quoted in the 15 percent to 17 percent range. However, virtually no loans were made at these high rates. Loans closed were largely based on commitments made months earlier or represented "creative financing" balloon notes, short-term rollover mortgages, and other innovations. Analysts contend that a viable conventional mortgage market must await a drop in mortgage rates to the 11-13 percent range.

As in the case of autos, home sales have been depressed by rapidly rising prices. Since 1974 the median price of homes has doubled, reflecting rising costs of labor, materials, and developed land. Higher prices combined with higher interest rates priced many potential buyers out of the market.

The financial picture in housing is complicated by the fact that rising interest rates have placed S&Ls, the principal mortgage lenders, under growing financial pressures. Many S&Ls have reported net outflows of savings as depositors have shifted to high-yielding money market instruments. Attempts to counter this outflow by offering money market certificates tied to six-month Treasury bill rates have caused some major S&Ls to suffer operating losses for the first time in their history.

Hope for improvement

Early in 1981 the economy was showing surprising strength. Employment rose again in January, and some large retailers reported a favorable level of sales. Motor vehicles and housing remained seriously depressed, with the Midwest still shouldering a disproportionate share of the burden.

Credit restraint and high interest rates are intimately related to the rapid pace of price inflation. Ready availability of credit under standard contracts at affordable rates provided the underpinnings for the great expansion of the housing and motor vehicle industries after World War II. If inflation cannot be reduced well below the two-digit pace and interest rate volatility cannot be reduced, the whole structure of financing home and vehicle purchases must be modified to protect both borrowers and lenders.