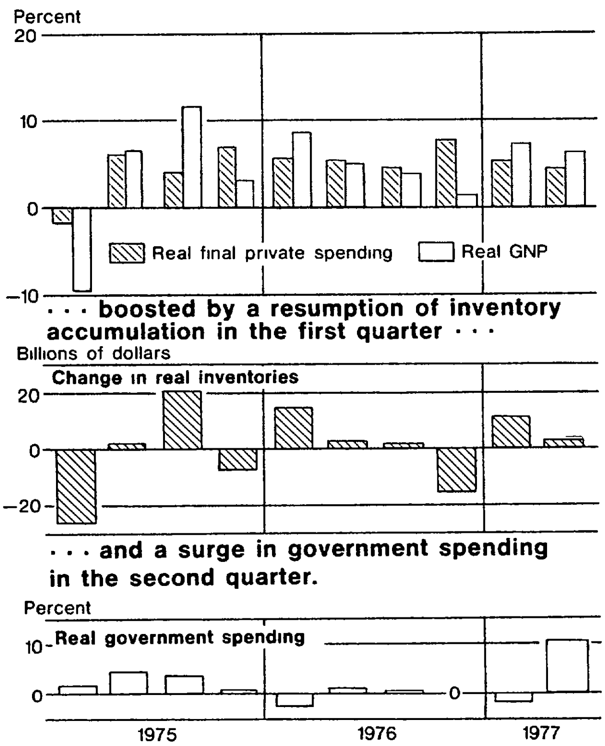
The business situation
Current developments

Chart 1

As the growth of real final private spending slowed somewhat in the first half of 1977, gross national product rose briskly · · ·



All data are expressed as annual rates of change in levels denominated in 1972 dollars

Source United States Department of Commerce

The performance of the United States economy during the first half of 1977 showed considerable underlying strength and resiliency. After snapping back quickly from the depressing effects of the most severe winter in many years in the eastern half of the nation, economic activity continued to post solid gains through the spring. At the same time, prices, aggravated by some special factors, rose appreciably more rapidly than in 1976.

With the approach of summer, the ongoing expansion seemed to be settling down to a more sustainable pace. But it also appeared to have become more broadly based, and upward price pressures appear to have slackened. Consequently, prospects seem good for further increases in activity during the remainder of the year, although probably at a more moderate rate than that of the first half.

The resurgence in economic activity during the late winter was not in itself surprising. Signs of a pickup were clearly evident late last year following the much discussed "pause" in the rate of advance. Hence, a rebound from the temporary setback dealt by the bitter winter weather in the East and Midwest was generally expected. The stamina that the economy displayed on the rebound, however, surprised all but the most optimistic observers. Back in early February, amidst widespread layoffs and disruptions to production in the wake of curtailments of natural gas supplies to industry and scattered blizzards, many analysts were looking for first-quarter growth in real gross national product (GNP) no better than half the 7.5 percent annual rate of growth eventually shown in revised data for the period.

To be sure, a significant part of the first-quarter gain in real GNP represented a resumption of inventory accumulation following a small reduction in stocks during the preceding quarter. Real final spending in the first quarter rose at a much more moderate annual rate of 3 8 percent, nearly a full percentage point less than its average rate of advance since the current recovery got under way in the spring of 1975, although probably close to the economy's longer run growth potential. That figure, however, understates the strength of private demands in the first quarter. Total final sales were held down by a decline in real expenditures on goods and services on the part of state and local governments as well as the Federal Government. (The well-publicized shortfall in Federal outlays is analyzed in the article beginning on page 13). As may be seen in Chart 1, real *final private* spending increased in the first quarter at an annual rate of 5.3 percent, only slightly below the average rate of increase during the current economic expansion.

The growth of real final private spending slowed to an annual rate of 4.4 percent in the second quarter of 1977. Real GNP continued to rise strongly—at a 6.4 percent annual rate, according to preliminary estimates—spurred by a substantial increase in outlays by all levels of government as well as by a further advance in the rate of inventory accumulation. Residential construction activity also quickened significantly in the second quarter The slowdown in the rate of growth of real final private spending reflected smaller increases in both personal consumption expenditures and business fixed investment than in the first quarter.

The economy's advance was much less dependent upon the automotive sector in the second quarter than in the first three months of the year New domestic car sales rose strongly over the first quarter, reaching a near-record annual rate of 10 1 million units in March While domestic car sales settled back to a 9 3 million rate in the second quarter, sales of imported cars surged, capturing 21 percent of the market in April and May as compared with the roughly 15 percent share of recent years. Sales of imports declined somewhat in June as sales of domestic models picked up. Altogether, sales of new domestic and imported cars in the second quarter totaled 11 7 million units (annual rate), exceeding the record high yearly sales rate of 11 4 million reached in 1973 For the first half as a whole, new car sales nearly matched the 1973 rate

In the consumer sector, the rise in spending on automotive products accounted for more than half the first-quarter increase in real consumption expenditures During the next three months, consumers' outlays on automotive products are estimated to have remained practically unchanged from the first-quarter level. On the other hand, household purchases of other consumer durable goods—such as furniture, appliances, and TV sets—rose briskly in the second quarter Consumers' outlays for nondurable goods actually increased more than their spending on durables during the first half of the year. The bulk of the increase in spending for nondurables, however, was dissipated in higher prices, especially for foods. In real terms, consumption of nondurable goods barely inched upward in the first half.

Consumer spending appears likely to advance in real terms in the months ahead. The much slower rate of increase in food prices that seems to be in the offing should help to strengthen consumer confidence and to leave a larger part of incomes available for discretionary spending. Purchases of household durable goods are likely to be stimulated as the many housing units started in recent months are completed and readied for occupancy At the same time, consumer spending may be restrained somewhat as households seek to restore the balance between their savings and their disposable incomes. The savings rate has already recovered substantially from the abnormally low 4 1 percent rate in the first quarter. Nevertheless, at 5.5 percent the estimated second-quarter savings rate was still below the average of about 6 percent over the past quarter century. With incomes continuing to grow, a further rise in the savings rate would be consistent with moderate growth in personal consumption expenditures during the second half of 1977. It is unlikely, however, that consumer spending will resume the position of leadership in the economic advance that it occupied in the first two years of the current recovery, when real consumption rose at an average rate of 6 percent per year.

Another reason for expecting a slowing in the rate of GNP growth lies in the behavior of business inventories After a slight reduction in the level of inventories in the fourth quarter of 1976, investment in inventories accounted for nearly half the rise in real GNP in this year's first quarter and contributed more than one eighth of the second-quarter increase, according to still incomplete data (middle panel of Chart 1) Despite the first-quarter buildup, business sales rose so strongly that manufacturing and trade inventories were equal to only 1 43 months of sales in March, down from 1.46 at the end of 1976 and one of the lowest levels since the Korean war With inventory accumulation increasing rapidly and sales declining slightly, by the end of May the inventory-sales ratio climbed back to 1 46, where it had stood at the completion of the mild inventory correction late last year Hence, the overall level of inventories in May (the latest data available) appeared to be reasonably well balanced with sales. If this apparent balance is to be maintained, the inventory sector is unlikely to contribute much thrust to GNP in the months ahead.

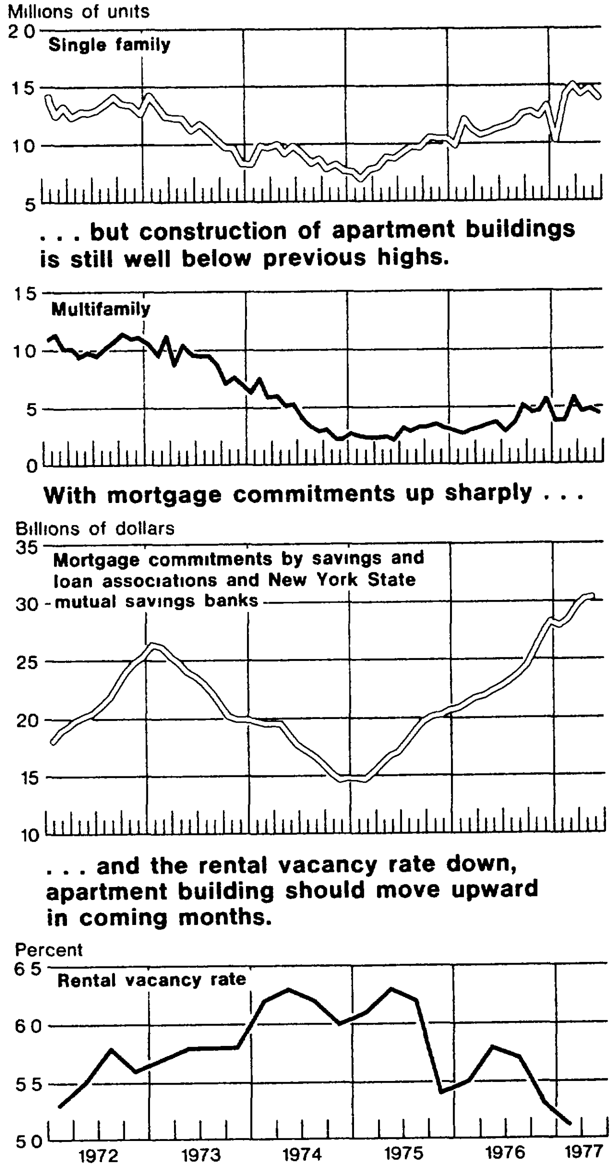
Government spending for goods and services continued relatively sluggish through the first three months of 1977, actually declining a bit in real terms. In the second quarter, however, government spending increased significantly in real terms for the first time since the third quarter of 1975 (see the bottom panel of Chart 1). The past quarter's upsurge in government spending was pronounced, accounting for nearly a third of the growth in real GNP. It was, moreover, spread among state and local governments as well as both defense and nondefense spending by the Federal Government. As indicated on page 17 of the following article, the "underspending" in the defense sector appears to have ended in the second quarter, and various advance indicators of defense spending point to further sizable increases ahead. Despite the continuing fiscal problems of certain localities such as New York City and the apparently continuing "underspending" on Federal grants, state and local governments as a whole are enjoying growing budgetary surpluses. And their revenue positions stand to benefit further as the countercyclical revenue-sharing funds legislated in the Tax Reduction and Simplification Act of 1977 come on stream. Thus, it appears likely that government spending will be supportive of GNP growth in coming quarters.

Consumer outlays on new homes have contributed significantly to the current upswing Recovering quickly from the effects of the extreme cold early this year, private housing starts in March jumped to a seasonally adjusted annual rate of 2.1 million units, a level not seen since the boom of early 1973. The pace has moderated somewhat since then—particularly in the West, where incipient signs of speculative fever in the housing market had been discerned—but starts in the second quarter were running 31 percent above year-earlier levels. While single-family housing has been in especially strong demand, apartment building in recent months has also emerged from its doldrums of the previous two years. Rising rents, declining rental vacancy rates, and ample availability of mortgage financing suggest the likelihood of a further step-up in building activity in the multifamily sector in the months ahead (see Chart 2).

Capital spending has yet to display clear signs of breaking out of its relatively sluggish growth pattern While real nonresidential fixed investment rose at an annual rate of 19 percent in the first quarter of 1977—by far the largest rise in the current expansion—the

Chart 2

Single-family housing starts have been running near record levels . . .



All data are seasonally adjusted

Sources United States Department of Commerce, Federal Home Loan Bank Board, and Savings Banks Association of New York State second-quarter increase was only half as large. As in the case of consumer spending, the gain in capital spending in the second period was less concentrated in automotive purchases than during the first three months of the year. Moreover, real plant construction activity picked up in the second quarter, after showing virtually no growth over the preceding four quarters.

The May-June Department of Commerce survey of planned expenditures for plant and equipment suggests an increase of 6-8 percent in real spending this year over 1976. Several private surveys indicate larger advances, but the Commerce survey has a relatively good track record. Some advance indicators of capital spending look stronger. For example, manufacturers' capital appropriations in the first quarter were 30 percent above the year-earlier level. In April and May, real contracts and orders for plant and equipment averaged 11 percent above the first-quarter average. However, the strength of this official leading indicator of economic activity was exaggerated by a bunching of large contracts for power plants. New orders for nondefense capital goods rose strongly in June after showing little growth from January through May. In short, the outlook for the hitherto lagging business capital spending sector does show indications of strengthening, but the extent of that strengthening is by no means certain.

A decisive resurgence of capital outlays to levels consistent with the sustainable expansion required to absorb the unemployed will depend on a further strengthening of business confidence. A number of factors have acted to inhibit such confidence, including the uncertainties surrounding environmental regulations, tax policies, and the energy situation. The most pervasive influences, perhaps, have been those associated with the threat of inflation, with the distortions and complications it brings to calculations of costs and profits, and with the spectre it evokes of restrictive policies and the possibility of direct controls.

Prices were generating rather gloomy news during the early months of the year, but the picture appeared to be brightening somewhat toward midyear. The rise in the seasonally adjusted consumer price index, which had been contained to a monthly average of 0.4 percent in 1976, jumped to 0.8 percent per month during the first four months of this year. In large measure, the step-up in the inflation rate was due to advances in food prices that were related to weather conditions Consumer food prices had remained practically flat last year but went up by an average of 1.3 percent during the January-April period. Retail food prices rose more slowly in May and June, and the rate of advance in the prices of nonfood commodities had also moderated since a burst of increases in January and February. Nevertheless, the rises in the overall consumer price index of 0.6 percent in May and June were considerably faster than the average rate of increase last year.

Recent movements in wholesale prices may presage some relief from rapidly rising prices at the retail level, especially for food. Spiraling food prices were largely responsible for pushing wholesale prices up at an average monthly rate of 0.9 percent during the January-April period. As farm prices retreated thereafter, the wholesale index rose by only 0.4 percent in May. In June, when the decline in farm prices was joined by decreases in prices of processed foods and feeds and a sharp drop in raw industrial commodity prices, the overall index of wholesale prices fell 0.7 percent.

Nevertheless, the price situation leaves no room for complacency. It will take some time before the moderation in wholesale food prices is fully reflected at the retail level. In any event, 1977 as a whole is bound to witness a significantly greater rise in prices than did 1976. As a result, there is danger that the excessive increases in consumer prices so far this year could lead to a step-up in wage demands, and thus place additional upward pressure on production costs and, in turn, on prices.

The demand for labor was very strong during the first half of 1977. Payroll employment swelled by an average monthly rate of nearly 300,000, an impressive performance by any standard. As a result, the proportion of the adult population gainfully employed has climbed to within 0 2 percentage point of its record peak in early 1974, when the last recession was just getting under way. The unemployment rate has been generally on the decline since last fall, from 8 percent in Novomber to 6.9 percent in May, but edged upward to 7.1 percent in June. The sharpness of the November-May decline may in part have reflected statistical difficulties The seasonal adjustment procedures used at present may tend to lower the seasonally adjusted unemployment levels unduly in the early part of the year and to raise them in the latter part of the year. Given this apparent bias in the seasonal adjustment, the jobless rate could prove to be rather sticky over the balance of the year