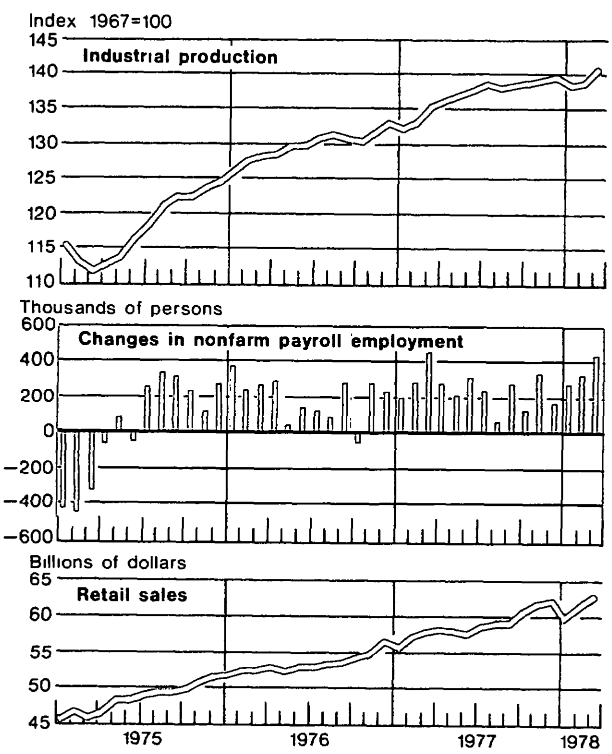
The business situation
Current developments

Chart 1

Selected Indicators of Business Activity



All data are seasonally adjusted

Sources Board of Governors of the Federal Reserve System, Bureau of Labor Statistics Bureau of the Census

The first signs of spring brought a spirited recovery to the United States economy after the winter's stagnating activity. Sales, production, and employment were all bounding upward by March (Chart 1), and fragmentary evidence pointed to a further quickening of the pace of business in April. Unfortunately, inflation appeared to be heating up even during the winter doldrums. To be sure, the most noticeable price increases were on food products whose supplies had been disrupted temporarily by severe weather conditions. But the underlying inflation rate appeared to have moved up a notch as well, spurred by the renewed vitality of aggregate demand, possibly deteriorating agricultural supply conditions, the aftermath of earlier declines in the value of the dollar on the foreign exchange markets, and a multitude of governmental measures that have the incidental effect of putting upward pressure on prices.

Unusually cold and stormy weather severely hampered business activity over much of the nation this past winter. The 110-day bituminous coal strike was an additional depressant in the Midwestern region. The Department of Commerce estimates that those two factors shaved 2½ to 3 percentage points from the growth of real gross national product (GNP) in the first quarter of 1978. According to preliminary estimates, real GNP decreased slightly in the first quarter, at an annual rate of 0.6 percent. If it withstands subsequent revisions, that will have been the first decline in real GNP since the opening quarter of 1975, which marked the nadir of the last recession.

The depressant effect of the weather was evident in the pattern of spending that emerged in the first quarter. Especially hard hit was construction activity—residential and commercial—and easily postponable consumer purchases of automobiles and household durable goods. Government expenditures also declined in real terms, and the balance of net exports of goods and services deteriorated further, according to preliminary and incomplete data. On the other hand, consumer purchases of services increased rapidly, and business investment in producers' durable equipment continued to rise modestly in real terms.

The winter's disruptions apparently affected final sales more than production. Consequently, inventory accumulation is estimated to have increased in the first quarter from the relatively slow fourth-quarter pace. Based on data through February, inventories generally appeared to be comfortable. Inventory-sales ratios were below year-ago levels except in the retail trade sector. Domestic automobile inventories loomed especially large in relation to slumping sales in January and February. The March resurgence in auto sales, however, substantially reduced the stock-sales ratio.

In March, industrial production recovered strongly from the winter slowdown After dropping 0.8 percent in January and showing a rise of only 0.3 percent in February, industrial output rose 1.4 percent in March. The rise was widespread except for declines in output of utilities. Production of consumer goods was especially strong, with the largest gains in production of automobiles and household durable goods Output of business equipment, construction supplies, and materials all posted sizable increases as well. And output of mines rose sharply with the end of strikes in the iron ore and coal industries.

The prolonged strike of 160,000 coal miners never did have the dire consequences that some had predicted. Midwestern utilities were able to stretch fuel supplies with the help of voluntary conservation measures by customers, conversion to oil or gas generating capacity, availability of Western and nonunion coal supplies, and purchases of power from other utilities. Some moderation in the weather after January also facilitated declines in power consumption in February and March. According to a special survey conducted by the Bureau of Labor Statistics, layoffs of factory workers precipitated by the coal strike peaked at only 25,500 in early March. Upon the settlement of the strike, coal production quickly returned to normal and was running above year-ago rates by early April.

Employment growth was strong throughout the winter. Apparently looking beyond the temporary dislocations in production and sales, employers added successively larger numbers of workers to payrolls during the first three months of the year. For the first quarter as a whole, nonfarm payroll employment grew at an unusually rapid 4.4 percent annual rate. (The returning coal miners will show up in the April data.) The gains were widespread among industries. Nearly three quarters of 172 nonfarm industries surveyed reported increased employment in March. The average factory workweek, which had fallen sharply in January and remained relatively short in February, returned to normal in March. The unemployment rate fell to an average of 6.2 percent in the first quarter from 6.6 percent in the preceding quarter, as the proportion of the population with jobs rose to a new postwar high.

Consumer spending began to recover in February, when retail sales rose 3 percent after declining 3.5 percent in January. Sales rose 1.9 percent further in March. The February increase in retail activity was broadly based, with an especially large rise in sales of household durable goods after a sharp drop in January. The early Easter and a series of dealer sales-incentive contests by automobile manufacturers make the significance of the March sales gains rather difficult to assess. Sales of new domestic-type automobiles recovered strongly in March, rising to a seasonally adjusted annual rate of 9.9 million. By comparison, 9 7 million domestic-type cars were sold in the peak year of 1973. Sales strengthened a bit more in the first twenty days of April. Imported cars continued to sell well, at least through March, in spite of a succession of price increases in recent months.

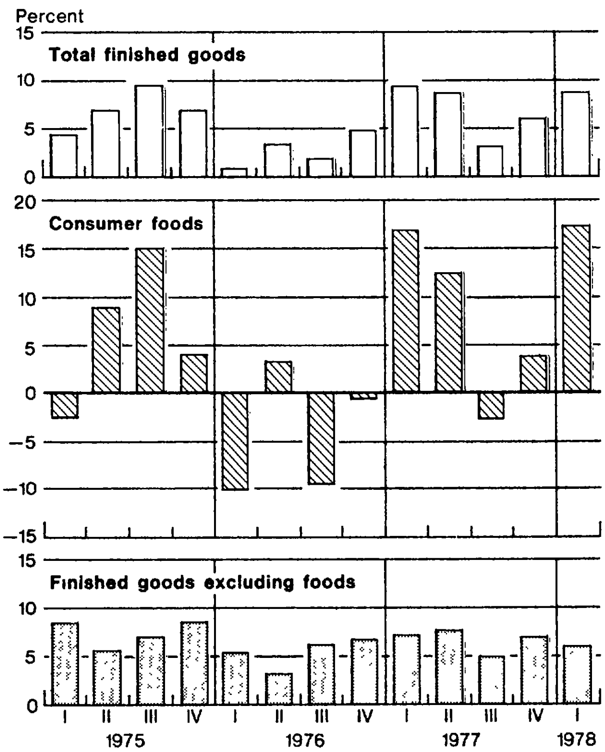
Construction activity quickened in March after two months of weather-related disruptions. Private housing starts rebounded to a seasonally adjusted annual rate of 2.07 million units, but that was still below the 2 15 million rate of starts in the fourth quarter of last year. Starts of single-family dwellings, in particular, remained below the record pace of the fourth quarter. Starts of multiple-unit buildings, on the other hand, climbed in March to the highest rate since early 1974. Government assistance programs, rising rents, and historically low rental vacancy rates may stimulate further increases in apartment construction, which is still running well below the 1972-73 record.

The near-term prospects for business capital spending also look bright, although the longer term outlook remains cloudy. The Commerce Department's survey of plant and equipment spending plans, taken in January and February, indicated a disappointing 10 9 percent increase in 1978 over last year's level. Most forecasters look for a somewhat stronger growth in capital spending, and some indicators seem to be consistent with that view. For example, new orders for nondefense capital goods increased 6 5 percent in the first quarter of 1978 over the rate of the preceding quarter. These orders were 20 percent higher than a year earlier. Similarly, construction contracts for com-

Chart 2

Producer Prices of Finished Goods

Quarterly changes at annual rates



All data are seasonally adjusted

Source Bureau of Labor Statistics

mercial and industrial buildings, measured in terms of floor space, rose 8 percent from the fourth to the first quarter. According to the F. W. Dodge Division of the McGraw-Hill Information Systems Company, such contracts in the first quarter of 1978 were up 26 percent from a year earlier.

The pace of price increases quickened during the early months of 1978. According to preliminary estimates the broadest measure of prices, the implicit price deflator for GNP, increased in the first quarter at an annual rate of 7.1 percent. That was up from 5.9 percent in the fourth quarter of last year and an average of 5.4 percent during the past two years. In part, the uptick in prices reflected temporary effects of the harsh winter weather in interfering with agricultural supplies. As shown in the middle panel of Chart 2, producer prices (formerly known as wholesale prices) of consumer food products spurted at an annual rate of 17.3 percent in the first quarter. At the same time, producer prices of other finished goods, shown in the bottom panel of Chart 2, rose at an annual rate of 6 percent, which was in line with the average increases over the past two years.

The consumer has yet to feel the full brunt of the price pressures that built up during the winter. Some of the increases in producer prices of finished goods may be passed on to consumers in the near future. Furthermore, some of the sharp, first-quarter increases in prices of crude materials—including plant and animal fibers as well as many foodstuffs—have yet to be passed through to prices of finished products. The first ripple from the coal labor settlement surfaced in early April with the $5.50 per ton increase in steel prices. According to the latest survey of the National Association of Purchasing Management, 64 percent of respondents reported paying higher prices in April, up from 25 percent as recently as last November.

The longer run price situation is also disquieting. Most forecasters look for an expansion in economic activity during the next several quarters strong enough to shrink further the margins of unused labor and capital resources, which may lead to an intensification of price and wage pressures. Widening ripples may be expected from the coal labor settlement, which is estimated to yield increases in wages and benefits totaling about 39 percent over the three-year life of the contract While the coal industry has not traditionally been a pattern setter in labor negotiations, some observers feel it may have established a target for future settlements in other industries. The depreciation of the dollar on the foreign exchange markets has already forced up the prices of certain imported goods and facilitated increases in prices of domestically produced goods that compete with imports, and more increases may well be in the offing. Many governmental policies threaten to put further upward pressure on the price level: increased farm price supports, "set aside" programs to restrict output of wheat and feed grains, import restrictions, and myriad regulations that raise business costs. Increases in payroll taxes and in the minimum wage contributed materially to the 14 percent annual rate of increase in compensation per hour worked in the private business sector during the first quarter. Unless modified, further increases that have already been legislated will continue to raise labor costs in the future. In short, there has been cause for increased concern over the outlook for inflation. But that heightened concern is now also being reflected in public policies, including President Carter's call for a cooperative anti-inflationary effort on the part of Government, business, and labor.