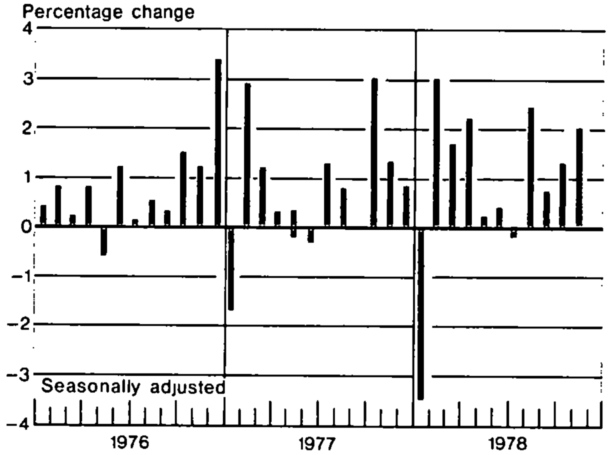
The business situation
Current developments

Chart 1

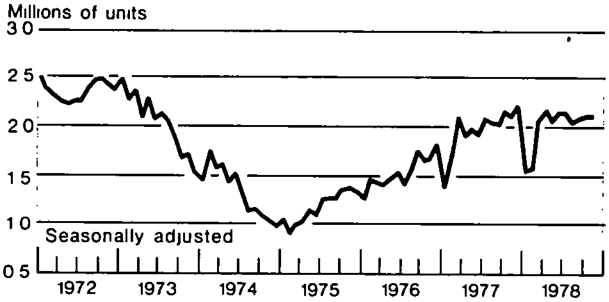
Retail sales rose strongly in late 1978 . . .

Percentage change



. . . and housing starts continued at a high rate.

Millions of units



Source: United States Department of Commerce

The pace of business activity in the United States quickened in the closing months of 1978. Retail sales rose strongly in October and November. Industrial production posted solid advances. Employment surged, and the proportion of the population with jobs rose to a new record high. Capital spending commitments advanced strongly, both for equipment and for industrial structures. Yet, despite the abundance of indications of robust business activity, the mood was far from euphoric. Various surveys suggested considerable anxiety on the part of consumers and business executives over the outlook. There are, indeed, ample grounds for concern over the future.

Inflation is at the root of many of the anxieties that haunt consumers and business people, and justifiably so, for inflation contains the seeds of the destruction of the economic expansion. Inflation has encouraged consumers to incur heavy debt burdens, partly as a hedge against more inflation to come. Inflation, in combination with the tax system, impairs the profitability of investments and complicates business affairs. Inflation has helped to fuel the depreciation of the dollar on the foreign exchange markets, which, in turn, has further exacerbated domestic inflation. Inflation has served to drive up interest rates, both by building inflation premia into rates and by necessitating restrictive monetary measures that tend to push interest rates still higher in the near term. Ultimately, success in defeating inflation will lead to much lower interest rates and a more stable economic environment, but that time seems still remote today.

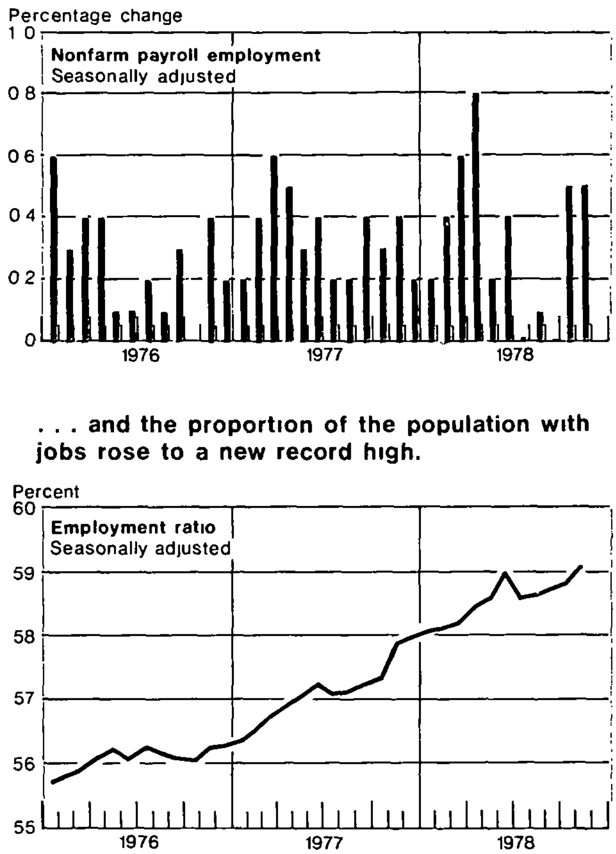
While caution, even apprehension, characterized attitudes toward the future, most indicators of business conditions were moving decisively higher as 1978 drew to a close. For example, retail sales rose strongly during October and November (Chart 1), and year-end holiday buying was brisk This spending apparently surpassed the relatively rapid growth of personal income, suggesting a further decline in the rate of personal savings from the already low 5 2 percent of disposable income that was saved in the third quarter Such a low savings rate is not likely to be sustained for long in the face of the declining confidence reflected in surveys of consumer sentiment, especially in light of the historically high debt burdens that consumers bear in relation to their incomes Thus, some retrenchment of consumer spending in coming months is likely

Another sector that appears headed for a slowdown is residential construction The demand for housing has remained surprisingly robust in the face of record high mortgage interest rates. Private housing starts continued in November at an annual rate of 2 1 million units, the rate that has generally prevailed since mid-1977 (Chart 1) The availability of credit to finance home purchases has been maintained at a high level with the help of some financial innovations For example, the six-month certificates with yields tied to the six-month Treasury bill rate, authorized beginning last June, have enabled thrift institutions to avoid the disintermediation that marked previous episodes of high interest rates The expansion of the secondary market for mortgages, through such innovations as mortgage-backed securities, also has facilitated the flow of funds into the housing sector However, mortgage interest rates have risen to such levels that legal rate ceilings may cause a slowdown in commitments of funds to residential mortgages in at least one third of the states. Furthermore, high financing costs are likely to temper demand for housing in coming months.

Chart 2

Employment surged in the autumn . . .

. . . and the proportion of the population with jobs rose to a new record high.



Source United States Bureau of Labor Statistics

The crosscurrents of strong current activity against a doubtful future come into sharp focus in the business investment sector New orders for nondefense capital goods were booked at a rapid pace during the three months, August through October. Despite a sharp drop in November, such orders were 26 percent above the year-earlier rate, and backlogs of unfilled orders were up 24 percent to almost $105 billion Similarly, contracts for commercial and industrial buildings, measured in floor space, rose 29 percent in the year ended in November, according to the F W Dodge Division of the MGraw-Hill Information Systems Company In spite of these strong near-term commitments, responses to surveys of capital spending plans display considerable caution The most recent one, the Commerce Department's survey of plant and equipment spending plans for the first half of 1979, is broadly consistent with earlier private surveys that indicated little increase in planned outlays in real terms during 1979 Inventory investment decisions also continue to be dominated by cautious attitudes While there may still be excess stocks in some retail lines, inventory-sales ratios overall are at relatively low levels

The quickening tempo of economic activity late in 1978 generated jobs at an impressive pace Nonfarm payroll employment, after barely inching upward during the summer, rose 0 5 percent in October and again in November (Chart 2). Employment growth was especially rapid in the goods-producing sectors—manufacturing, construction, and mining—and was widespread among industries Of 172 nonagricultural industries surveyed, about three quarters reported increased employment in October and November. Over the twelve months ended in November, almost 3.5 million persons were added to nonfarm payrolls, representing a 4.2 percent growth The unemployment rate dropped to 5 8 percent of the civilian labor force in

October and held at that rate in November. Except for an aberrant 5.7 percent last June, that was the lowest rate of unemployment since August 1974. Perhaps a better measure of the tautness in the labor market is reflected in the record high 59.1 percent of the population that had jobs in November (Chart 2).

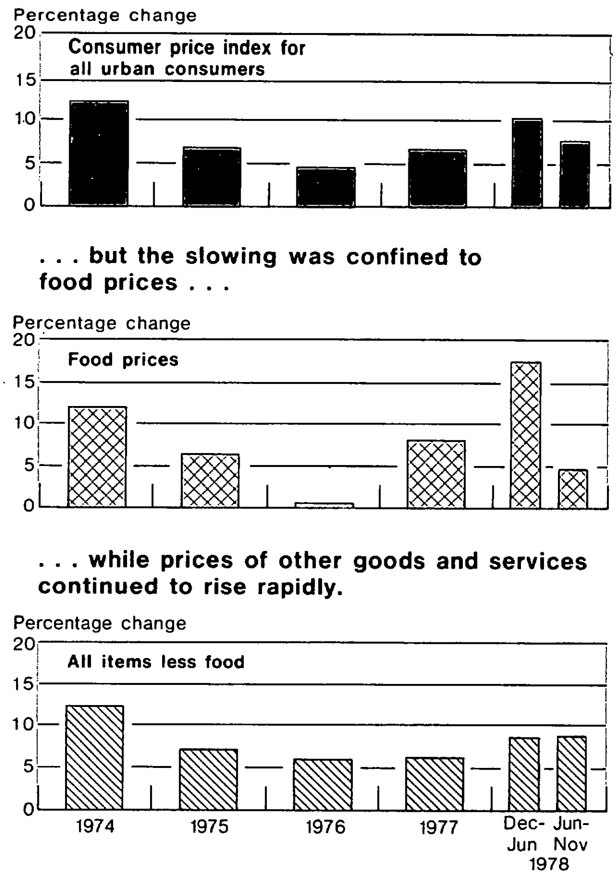
The rapid growth of employment helped to boost incomes and to stimulate spending, but it bodes ill for labor productivity. The growth of productivity has been lagging seriously of late. In the year ended with the third quarter of 1978, there was virtually no gain in output per hour worked in the private business sector. Consequently, the 9 percent increase over that period in compensation per hour resulted in a similar rise in labor costs per unit of output. Given the dominance of labor costs in overall costs of production in most industries, it is not surprising that consumer prices also rose at an annual rate of about 9 percent from the beginning of 1978 through November, compared with 6.8 percent over the course of 1977 and 4.8 percent during 1976. The overall rate of inflation slowed somewhat after the middle of 1978, but the slowdown was confined to food prices, which had escalated sharply during the first half of the year (see Chart 3). Prices of nonfood goods and services continued to rise at a rapid rate.

The forces exerting upward pressure on prices will be powerful in 1979. The acceleration of consumer prices in 1978 will spawn wage adjustments for several million workers under cost-of-living agreements (COLA) of collective bargaining contracts as well as catch-up raises for many more workers who are not covered by a formal COLA. The increases in the minimum wage and in social security taxes that took effect on January 1 will directly increase labor costs. Energy prices will be augmented by the 14.5 percent increase in imported crude oil prices (to be effected in four steps in 1979) that was agreed upon by the Organization of Petroleum Exporting Countries, as well as the measured steps toward decontrol of natural gas prices stipulated in the energy bill that was finally enacted late in 1978. Continuing adjustments to the depreciation of the dollar during the year ended last October also are likely to exert significant upward pressure on domestic prices for some time.

Thus, the near-term price outlook remains worrisome. Eventually, however, a stronger and more stable dollar will provide a significant check to inflation, both psychologically and in the form of lower import prices. The outlook may also be brightened considerably by widespread cooperation in the spirit of the President's anti-inflation program. The key to the program is moderation of labor cost increases, and 1979's heavy collective bargaining calendar will put the program to a severe test. There was, in fact, apparently some moderation of wage increases in the latter part of 1978. As measured by average hourly earnings of production and nonsupervisory workers in the private nonfarm sector (adjusted to eliminate the effects of interindustry shifts of employment and of overtime in manufacturing), the rate of wage increases slowed from an annual rate of 8.5 percent during the first half of 1978 to about 7.5 percent in the second half. A continuation of that trend, in cooperation with the President's program, would do much to slow down inflation and to lessen the risks of serious economic instability.

Chart 3

Inflation slowed in the second half of 1978 . . .



Annual data are expressed as the change from December of the preceding year to December of the year shown. Data for 1978 are expressed at seasonally adjusted annual rates.

Source: United States Bureau of Labor Statistics.