The business situation
Current developments

Business activity picked up during the summer as the economy began to absorb the shock of the sharp increases in imported oil prices and recouped some losses inflicted by work stoppages during the spring. Employment continued to grow, and the unemployment rate ended the summer within the range that had prevailed for the past year. Spending for consumer goods, capital goods, and housing was sustained better than many had expected. Exports of goods and services continued to grow rapidly. At the same time, upward pressures on prices persisted unrelentingly. Nevertheless, wages continued to show relatively moderate rates of increase—especially wages of non-union workers—considerably slower than overall rates of price inflation.

Consumer spending—both for new cars and for other goods—rose strongly in August and September. While the disappearance of long lines at gasoline stations that had developed in some areas encouraged retail buying, shoppers in metropolitan areas such as New York apparently continued to favor centrally located stores accessible via public transportation in preference to suburban outlets. Consumers responded to price discounts and rebates offered by domestic automobile manufacturers seeking to clear out heavy inventories of the larger 1979 models. Sales of domestic-type passenger cars rose during August and September about 11 percent above the sales rate of the three preceding months, although they remained 6 percent below the year-earlier rate.

While consumer spending has held up much better than many had anticipated, some weakening of consumer demand appears to be in prospect. A number of considerations point in this direction. Domestic auto sales may diminish with the end of special incentives and rebates. Sales of durable household goods are likely to taper off as completions of new homes decline. Consumer purchases in general are bound to weaken if slower growth of jobs, or outright decreases in employment, reduce the growth of personal income. In real terms, disposable personal income has already fallen substantially this year, largely as a consequence of the acceleration of inflation. Consumer confidence has declined to a low ebb, according to a number of surveys, and increasing economic uncertainties may well depress sentiment further.

Purchases of durable goods, which are often financed by credit, are particularly vulnerable to adverse changes in consumer fortunes and attitudes. Record high debt burdens of consumers, in the face of heightening economic uncertainties and tightening credit conditions, may well instill more cautious attitudes in borrowers and lenders alike. Indeed, the growth of consumer instalment debt has already slowed somewhat in recent months, although it remains rapid by past standards. The personal savings rate, which has been very low in recent quarters, is likely to rise as households seek to increase their holdings of liquid assets as well as to liquidate debts in the face of growing uncertainty. In short, the signs point to a retrenchment by consumers in coming quarters.

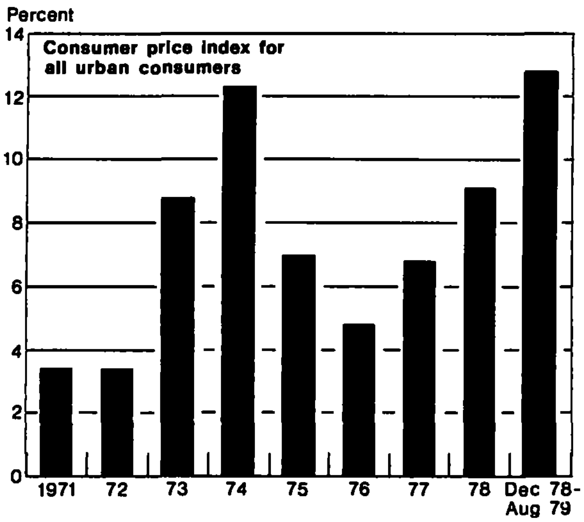
Residential construction continued relatively strong during the summer in spite of tightened credit conditions and rising construction costs. Single-family housing starts leveled off on a plateau of about 1.25 million units (annual rate) during the six months ended August. This was down from an average of almost 1.45 million during 1977 and 1978 but only slightly below the peak of the last housing boom in 1972. Construction of multifamily dwellings—spurred by Federal subsidy programs as well as historically low rental vacancy rates—continued close to the 1977-78 rate, but well below the hectic pace of 1972-73 when considerable overbuilding occurred.

Various innovations in the credit markets have helped to sustain a high level of residential construction this year. Money market certificates yielding interest rates tied to Treasury bill rates, which were authorized beginning in June 1978, have helped thrift institutions to maintain deposit flows better than in earlier periods of high interest rates. Innovations in the secondary market for mortgage-backed securities also have facilitated the flow of credit to the housing market (see the article beginning on page 1). While such innovations should help the housing market to avoid the extreme volatility of the past, tightening credit conditions are likely to dampen housing activity somewhat in coming quarters.

Business investment in productive facilities also has been sustained at a high rate. The Commerce Department's latest survey of business spending plans for plant and equipment, taken in late July and August, indicated a slight increase in capital investment plans during 1979 as compared with those shown in the survey taken three months earlier. The latest survey pointed to a 13.2 percent growth of spending on plant and equipment this year, about the same as last year's increase. Because of the step-up in inflation, however, a somewhat smaller increase in the physical volume of investment is indicated than last year's 5.6 percent. It is not unusual for capital spending to continue relatively strong as other components of aggregate demand begin to weaken. If the expected slowing of consumer spending occurs, however, a slowing of capital investment is to be expected as well. Indeed, data on spending commitments—both construction contracts for commercial and industrial structures and new orders for nondefense capital equipment—have been declining on balance in real terms over the past several months.

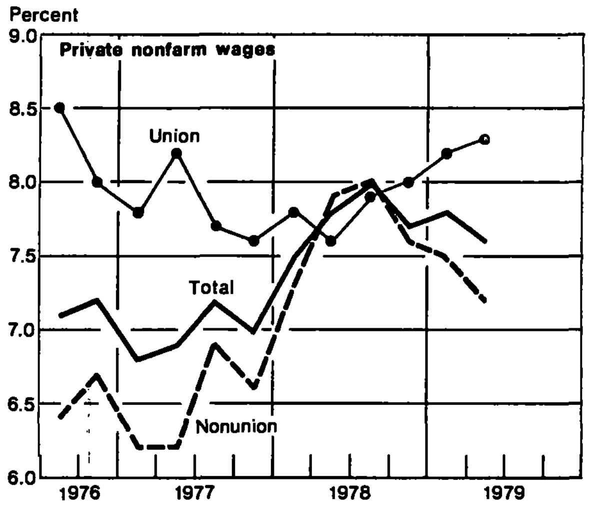
The growth of business inventories has been gradually speeding up since the middle of last year. In July, the book value of manufacturing and trade inventories surged 1.9 percent, the sharpest rise since September 1974. A significant part of that accumulation was in the automotive sector, where inventories were pared considerably in August, as production schedules were curtailed sharply and sales were stepped up. Overall, business inventories rose moderately in August by 0.8 percent. Outside the automotive sector, inventories in most lines of business appear to be reasonably balanced with the current rate of sales. Nevertheless,

Price inflation has worsened markedly this year . . .



Annual data are expressed as the change from December of the preceding year to December of the year shown. Data for 1979 are expressed at a seasonally adjusted annual rate.

. . . but nonunion wage increases have slowed somewhat.



Data represent employment cost index of private nonfarm straight-time hourly earnings, expressed as the change from four quarters earlier.

Source: United States Department of Labor, Bureau of Labor Statistics.

if consumer spending weakens, the same level of stocks might appear excessive. Moreover, the run-up in interest rates, by imposing higher carrying costs, produces incentives for cutting stocks. Thus, some inventory correction within the next several months would not be surprising.

Price developments continue to be distressing. The consumer price index for all urban households rose at an average rate of about 1 percent each month through the first eight months of the year. The resultant annual rate of increase of more than 12 percent slightly exceeded the previous postwar peak inflation rate in 1974 (left-hand panel of chart). The most drastic price increases were for energy. Reflecting the sharp in-increases in imported oil prices, consumer fuel and power prices rose more than 5 percent per month from January through August. The consumer price index continued to rise rapidly during the summer in spite of a virtual halt to increases in retail food prices from June through August. The respite from rising food prices may be about over, in view of the sharp increases in producers' prices of foods in August and September. Excluding both food and energy, consumer prices rose more than 0.8 percent monthly during the first eight months of 1979.

Notwithstanding the virulence of price inflation, the overall growth of wages does not appear to have accelerated. Average hourly earnings of production and nonsupervisory workers in the private nonfarm sector (adjusted to eliminate the effects of shifts of employment between industries and of overtime in manufacturing) rose 7.9 percent during the twelve months ended September 1979, which was slightly less than the increase during the preceding twelve months. The absence of wage acceleration may reflect the impact of the voluntary wage and price restraint program inaugurated by the President in October 1978. As may be seen in the right-hand panel of the chart, through the third quarter of last year wages in the union and nonunion sectors were behaving in their usual cyclical fashion. As labor market conditions gradually tightened during 1977 and 1978, the growth of nonunion wages began to approach that of union wages and, by the middle of 1978, slightly exceeded union wage growth according to the employment cost index compiled by the Bureau of Labor Statistics. Then, beginning in the final quarter of 1978, the growth of nonunion wages slowed while that of union wages accelerated. It thus appears that the wage restraint program has been more successful in nonunionized sectors than in the unionized sectors of the economy.

It would be understandable for those workers whose purchasing power has been seriously eroded by inflation to attempt to catch up with higher prices. However, it is impossible for Americans as a whole to recoup losses caused by the massive transfer of income to the oil-producing countries. If price stability is to be restored, it is imperative that external shocks, such as the imported oil price increases, not become built into the wage structure. In any case, real wages cannot increase over an extended period in the absence of improvement in the productivity of labor. As discussed in the article that begins on page 25, the growth of productivity in the United States has been slowing since 1967. Output per hour of work in the private business sector as a whole actually declined over the four quarters ended in mid-1979. Apart from restraint on the growth of money and credit, improving productivity is perhaps the most urgent imperative in the battle against inflation.