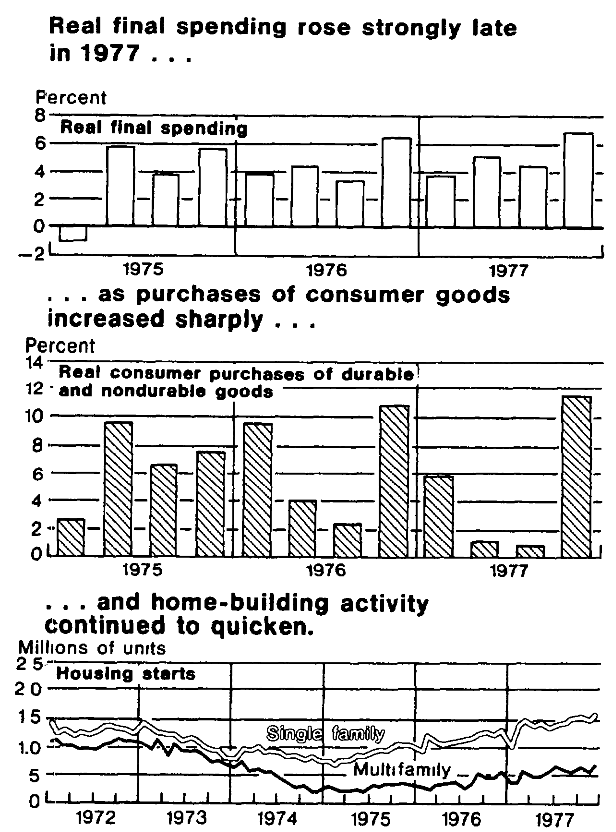
The business situation

Current developments



All data are seasonally adjusted. Final spending and consumer purchases are expressed as annual rates of change in 1972 dollars Housing starts are expressed as annual rates

Source United States Department of Commerce

The United States economy closed 1977 with an impressive display of strength. Final demands for goods and services, led by ebullient consumer buying, posted a large advance in the last quarter of the year. The growth of total production, it is true, slowed slightly, but this slowdown was due to a mild downward adjustment in inventory accumulation. By the year-end, strongly rising employment cut the overall rate of unemployment to the lowest level in more than three years.

The news on the price front was less encouraging. Consumer price increases did moderate in the second half of the year, but no reduction of the underlying rate of inflation was evident. Wholesale prices of industrial commodities continued to rise at a fairly steady clip at the year-end, and prices of farm products rebounded in the fourth quarter after four months of substantial declines.

Consumer spending, which had been rather lethargic during much of the spring and summer, provided most of the impetus to the economy during the final quarter of 1977 (chart). In real terms, consumer spending on goods rose at an annual rate of 11.4 percent in the fourth quarter, in spite of a slight reduction in purchases of automobiles. Retail sales posted strong gains in October and November before dropping back somewhat in December. The reported December decline, however, was entirely due to the seasonal adjustment. Actual sales were estimated in the advance report of the Commerce Department to have risen 18 percent from November to December.

The surge in consumer buying in the fourth quarter was fueled by an unusually large increase in personal income. Total personal income is estimated to have grown at an annual rate of 13.7 percent in current dollars during the fourth quarter. In large measure, that growth reflected surprisingly large increases in total employment. Incomes of farm proprietors also rose strongly, reflecting recent upturns in farm prices and sizable Federal price-support payments to wheat growers. Household savings grew proportionately even faster than consumption, and the ratio of personal saving to disposable income rose 0.2 percentage point in the fourth quarter to 5.7 percent, the highest level since the second quarter of 1976.

In part, demand for household goods has been stimulated by the need to furnish new dwellings. Residential construction activity rose vigorously over the past three years from very low recession levels. In the fourth quarter of 1977, construction was begun on one-family houses at a record seasonally adjusted annual rate of 1.57 million units, up 23 percent from a year earlier. Sales of new and existing single-family homes combined broke previous records late in the year. Starts of multifamily housing units rose to 636,000 in the fourth quarter, up nearly 29 percent from a year earlier but still well below the rates that had exceeded 1 million units annually in 1972 and the first half of 1973. In assessing the outlook for home building in 1978, many observers point to the slowdown of inflows into time and savings deposits at banks and thrift institutions—the principal suppliers of residential mortgage credit—as a potential restraining influence.

The growth of capital investment by businesses continued to lag behind the rise in residential construction during 1977. Business fixed investment is estimated to have grown in real terms at an annual rate of 8.4 percent in the fourth quarter and 8.8 percent for the year as a whole. For the entire period of the recovery from the 1973-75 recession, such investment has grown considerably slower than in previous recoveries during the postwar period. The bulk of the fixed investment that was undertaken by businesses in 1977 was in producers' durable equipment, while investment in structures increased only modestly. Prevailing Federal tax policies favor relatively short-lived capital investment by applying a 10 percent tax credit to outlays for equipment. More fundamentally, the reluctance of businesses to undertake increased investment in long-lived assets probably reflects uncertainties over the outlook for profitability and for government policies, especially those relating to taxes, energy, and environmental protection.

Those uncertainties have clouded prospects for capital spending in 1978. Indeed, the surveys of capital spending plans suggest slower growth of such spending in 1978 than in 1977. According to the survey taken by the Department of Commerce in December and released in mid-January, United States firms plan to increase real outlays on plant and equipment by only about 4.5 percent in 1978, assuming capital goods prices rise at about last year's 5.3 percent rate. (The predictive performance of the surveys of plant and equipment spending plans is analyzed in the following article.) Such a weak outcome is by no means foreordained, however. Actual capital spending often exceeds early plans during strong economic expansions. The increase of nearly 10 percent in new orders for nondefense capital goods from the third to the fourth quarter of 1977 may indicate such an outcome. Moreover, enactment of a tax package such as proposed by President Carter on January 21 might stimulate capital spending, especially for structures, by dispelling some of the uncertainties and by enhancing aftertax returns on capital investments. In addition to reductions in personal income taxes, and various other measures, the President proposed reducing the corporate income tax rate to 44 percent from 48 percent, making permanent the 10 percent investment tax credit against outlays for equipment and extending that credit to investments in manufacturing and utility structures.

In the fourth quarter of 1977, total real final sales grew at an annual rate of 6.8 percent, the strongest of any quarter since the current expansion got under way in the spring of 1975 Real gross national product (GNP) growth, however, was held to an estimated 4.2 percent rate as a result of a slowdown in inventory investment. Based upon two months of data for manufacturing and trade inventories, the adjustment of stocks appeared to be considerably milder than in the final quarter of 1976, when inventories were actually run down. Throughout the current period of expansion, business firms have been quick to correct incipient inventory excesses by cutting back orders and output. Such cautious policies have at times slowed production temporarily but have made for a reasonably balanced and sustained economic expansion.

The economy's buoyancy in the latter part of 1977 was especially evident in the labor market. Between September and December, total employment as measured by the Bureau of Labor Statistics (BLS) survey of households rose by 1.5 million persons, or at an annual rate of 6.8 percent, and the proportion of the population with jobs rose to a record level. The size of the gain has been greeted with some skepticism, but the separate survey of business establishments conducted monthly by the BLS also showed a strong employment picture. According to that survey, total nonfarm payroll employment rose over the last three months of the year by 670,000 persons, or at an annual rate of 3.3 percent, well in excess of the longer run growth of the labor force. The increase in payroll employment would have been even larger except for the strike that idled 160,000 bituminous coal miners beginning December 6.

The overall rate of unemployment (which is derived from the household survey) fell in December to 6.4 percent—the lowest reading in more than three years. Newly revised seasonal adjustment factors released by the BLS in January indicate a fairly steady decrease in the unemployment rate from 7.8 percent at the end of 1976. According to the old seasonal factors, the unemployment rate had dropped sharply in the early months of 1977 but had then fluctuated between 6.9 percent and 7.1 percent from April through November. The revisions affected only the pattern within the year; on both bases unemployment averaged 7.0 percent for all of 1977, down from 7.7 percent in 1976.

Consumer price increases slowed considerably in the second half of 1977. From June through December, the overall consumer price index rose at an annual rate of 4.4 percent, one half the rise in the first six months of the year. Much of the slowdown was in the food sector, where the annual rate of increase dropped to 2.7 percent in the second half from 13.2 percent in the first half of the year, when food prices were inflated by the effects of severe winter weather and drought at home and sharp increases in prices of some imported foods such as coffee. Advances in prices of nonfood items, both goods and services, also moderated to a 5 percent annual rate in the second half of 1977 from 7 5 percent during the first half.

Unfortunately, these developments do not necessarily signify any lessening in the underlying rate of inflation. Wholesale prices of industrial commodities forged ahead during the second half of the year at an annual rate of 6.7 percent, essentially the same as in the first half. Prices of farm products and processed food and feed rose strongly in the last three months of 1977 after declining for four months While the growth of compensation per hour worked in the private business sector slowed slightly in 1977, productivity gains slackened even more. Consequently, unit labor costs rose 6.1 percent in 1977, up from 4.7 percent the year before. At the beginning of 1978, labor costs were subjected to additional upward pressure from the increases in payroll taxes for social security and unemployment insurance and from the boost in the minimum wage. Such cost pressures make it very difficult to achieve any reduction in the underlying rate of inflation.