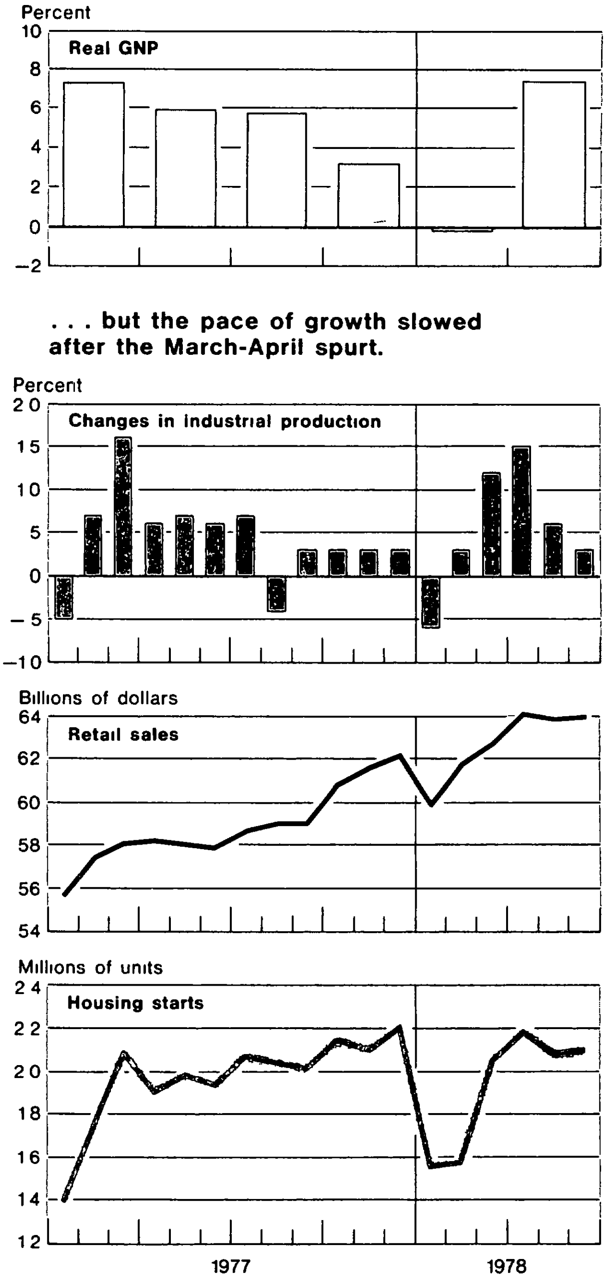
Chart 1

Reflecting the rebound from the depressed winter, economic activity rose strongly in the second quarter of 1978 . . .

. . . but the pace of growth slowed after the March-April spurt.



All data are seasonally adjusted GNP is expressed as annual rates of change in 1972 dollars Housing starts are expressed as annual rates

Sources. United States Department of Commerce and Board of Governors of the Federal Reserve System

The business situation
Current developments

The economic expansion settled down to a more moderate rate with the arrival of summer. After its heady rebound from the weather- and strike-plagued winter, the economy's return to a more sustainable pace of business activity was a welcome development. The recent slowing in growth, however, has not been accompanied by a lessening in the strong upward pressures on prices. The continued high rates of price increases are cause for serious concern. That inflation is now the nation's chief economic problem was underlined by the continued drop in unemployment—by midyear the unemployment rate was at its lowest level in almost four years.

For the second quarter as a whole, consumer spending posted a sizable increase; however, after a spurt in April, the pace of spending leveled off (third panel of Chart 1). In fact, retail sales dipped slightly in May and, according to the advance report, were essentially flat in June. There was a leveling, too, in the sales of domestic automobiles, which plateaued at a near-record pace of 10 million cars over the April-June period. At the same time, imported car sales weakened a bit in June, although sales averaged a hefty 2.2 million rate in the second quarter

The particularly high level of automobile sales in recent months has raised the question to what extent consumers may be buying in advance of higher prices. To the extent this is the case, current sales rates may reflect a borrowing from future months' sales. In any event, some slowing in the rapid growth of consumption in the past year is to be expected. The recent increases in consumer instalment credit and mortgage debt, which helped finance the step-up of consumer expenditures, may be approaching a level where households may question the prudence of expanding their debt burdens. In addition, consumer confidence has been impaired in recent months by the high rates of inflation. Thus, while the exceptionally strong gains in employment over the first half of the year are raising personal incomes, it seems likely that consumer spending may not keep pace with the growth of disposable income

Consumers' appetite for new homes remains strong, and sales of new single family homes are robust. In response to these demands, residential construction in the April-June period posted enormous gains from the depressed level of the first quarter. Despite some slippage in May, housing starts recovered in June and continue to run at better than a 2 million unit pace (bottom panel of Chart 1). Housing activity is widely expected to slow over the course of the year, partly in response to tightened credit conditions and slowing mortgage flows Mortgage interest rates on conventionally financed new homes reached a record high of 9.46 percent in June, after jumping more than 35 basis points since the start of the year. While mortgage flows have slowed, Federal agencies have moved to support the growth of funds that undergird mortgage lending by introducing two new savings instruments. Preliminary evidence suggests that these instruments are augmenting deposit flows, although at this early stage it is difficult to assess their long-term effectiveness. (For more detailed discussion, see the article beginning on page 37.)

Responding to the strong spurt in consumption in March and April, businesses aggressively added to their inventory stocks. As the sales pace slowed, inventory investment moderated somewhat in May because of a sharp cutback in wholesalers' inventory accumulation. In fact, nondurable stocks at the wholesale level declined slightly in May. Outside wholesaling, nonfarm business inventories rose somewhat faster in May than in earlier months of the year. While inventory-sales ratios in retailing and manufacturing edged up, inventory levels appear overall to be reasonably well-balanced with sales, although stocks may be rather heavy in some retail lines

Shaking off the effects of the severe winter weather, commercial construction activity rebounded in the second quarter, leading a step-up in businessmen's expenditures on capital investment. Signs of near-term strength are evident in a host of indicators. Production of business equipment has expanded sharply, and new orders for nondefense capital goods have been stepped up.

The longer term outlook for capital spending remains unclear, however. While the most recent surveys of planned plant and equipment spending point to a pickup in outlays, three available surveys offer disparate readings of the strengthening. The Commerce Department survey of April-May was especially disappointing, indicating an increase in spending of only 11.2 percent for the year, compared with last year's 12.7 percent rise. In contrast, surveys by McGraw-Hill and Merrill Lynch each point to a substantial rise in planned capital outlays of 15 or 17 percent. In historical terms, the Commerce Department survey has the best predictive performance of the three surveys, but the evidence of the two private surveys points to larger increases in capital spending.

Spending by state and local governments rose strongly in the second quarter. Payrolls expanded rapidly at the same time that construction activity accelerated with the coming of the spring thaw. Despite the strengthened fiscal position of state and local governments, the passage of Proposition 13 in California—which limits local property tax rates and makes it difficult to raise other state and local taxes—has raised questions about the outlook for continued growth of government demand. While cutbacks in California's state and local spending are unlikely to have significant impacts on the national economy, there could be wider ramifications as taxpayer revolts spread to other states.

The labor markets continued to expand sharply in the second quarter. The growth of payroll employment accelerated to a 6 5 percent annual rate from the already rapid 4.4 percent rate of growth posted in the first quarter. Part of this acceleration in job growth is accounted for by the return of striking miners, but the underlying employment gains remain substantial. As the quarter progressed, however, payroll employment growth slackened a bit, and there was some evidence suggesting that the breadth of the employment expansion may be losing momentum. The strength of the United States Department of Labor's establishment survey, however, is corroborated by the separate survey of households. Total employment as measured by the household survey posted an increase of close to 1.2 million jobs in the second quarter, continuing the large gains of recent years (top panel of Chart 2).

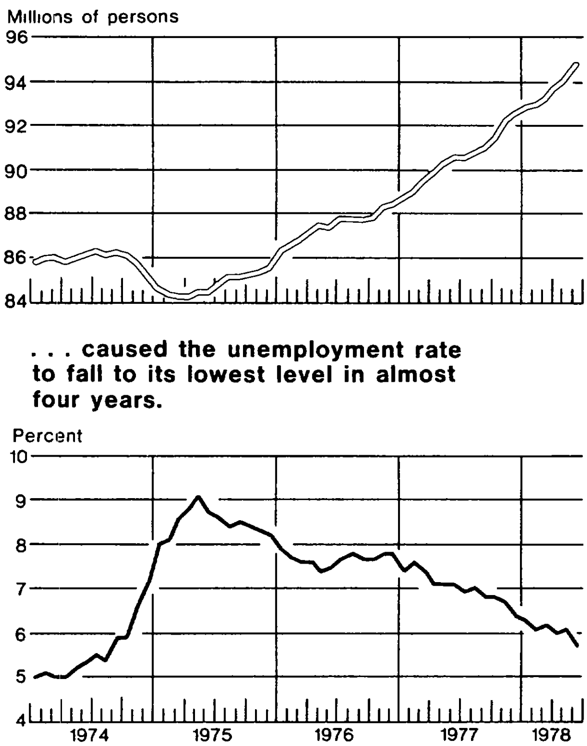
In the closing month of the quarter, employment posted a huge increase of more than 700,000, with sizable job gains in the agricultural and nonagricultural sectors. The overall unemployment rate fell 0.4 percentage point to 5.7 percent in June, marking the first time since October 1974 that the rate of joblessness fell below 6 percent (bottom panel of Chart 2). About half the decline in unemployment was due to a drop in teenage unemployment. While there are always reasons to suspect a statistical aberration, the underlying strength of employment suggests at least part of the decline will persist.

Although economic growth has begun to slow, the rate of inflation remains disturbingly high. Fanned by a

Chart 2

Continued rapid employment growth in the first half of 1978 . . .

. . . caused the unemployment rate to fall to its lowest level in almost four years.



All data are seasonally adjusted

Source United States Department of Labor, Bureau of Labor Statistics

run-up in food prices, inflation has flared at both the consumer and the producer levels. Over the first six months of 1978, the overall consumer price index rose at an annual rate of 10.1 percent. In this period, food prices spurted at an annual rate of 17.6 percent, led by an enormous run-up in the price of meats. There is reason to hope that the rate of food inflation will moderate in the second half of this year, but it seems less likely that the slowdown can match that of 1977. A year ago the surge in food prices was led by coffee, and the price of this commodity fell sharply in the second half of the year, as did major grain prices in the face of record harvests. This year the price increases have been concentrated in meats, led by sharply rising cattle prices. Because of the long period of time required to increase the size of the cattle herd, beef supplies are unlikely to expand before 1980 or even 1981. Any increases in alternative meats—pork and poultry—will have to be unusually large to offset the expected decline in beef supplies.

Even if food price advances moderate later in the year, pressures on nonfood prices are likely to persist. Prices of services have accelerated sharply through the first six months of this year, rising at an annual rate of 10.2 percent since the close of 1977. Producer prices for nonfood finished goods, led by run-ups in durables prices, have spiraled at an 8.0 percent annual rate over the first half of 1978. These price increases will exacerbate the pressures on consumer inflation.

The recent price deterioration will also have an unwelcome side effect on wage costs. The wages of more than 8 5 million workers under major collective bargaining contracts contain automatic cost-of-living agreements (COLAs). In addition to these direct effects, nonunion wages and wages in union contracts without COLAs are likely to respond to the acceleration in price inflation. Indeed, even prior to the recent bulge in prices some acceleration in wages was apparent. Average hourly earnings in the private nonfarm economy, adjusted for shifts in the interindustry composition of employment, rose 8.2 percent over the twelve months ended June 1978, compared with a 7 2 percent increase over the previous twelve-month period.