The business situation
Current developments

The widely expected slowing in the pace of the economic advance materialized in the third quarter. As measured by real gross national product, the growth of the nation's output of goods and services slowed to an annual rate of 3.4 percent from 8.7 percent in the second quarter (chart). Nevertheless, the economy continued to display impressive elements of strength in demands for consumer goods, housing, and capital goods. The rate of increase in the price level also slowed during the summer. Unfortunately, the relief on the price front largely reflected declines in some volatile agricultural prices following sharp increases earlier in the year. The underlying rate of inflation, as indicated by prices of nonfood goods and services, showed no signs of improvement.

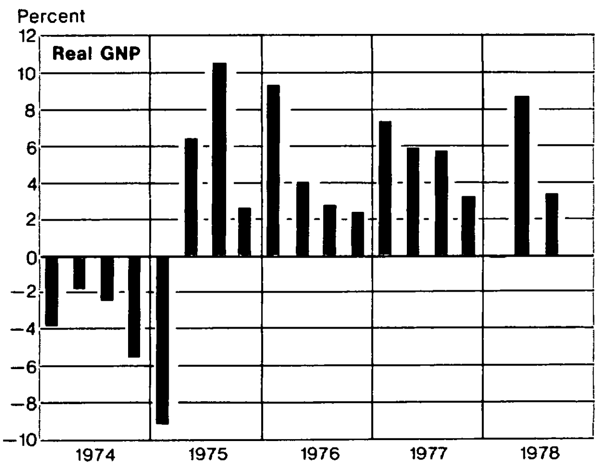
Consumer spending exhibited surprising strength in the third quarter. After dipping slightly in July, retail sales posted solid gains during August and September. Some of this buying undoubtedly was stimulated by anticipation of price increases in the future. Even as consumer buying was speeding up, the growth of personal income slowed appreciably in August and September as employment growth faltered. Personal saving in the third quarter amounted to only 5.1 percent of disposable income, significantly below the long-run average of about 6 percent. Unless the growth of personal income speeds up considerably, the growth of consumption is likely to slow down eventually as households seek to restore a more normal relationship of savings to income. The rapidly increasing share of consumers' incomes devoted to repaying instalment and mortgage debt may cut further into spending on goods and services.

Inflationary expectations also undoubtedly have played a role in the strength of demand for housing. For many households, real estate is the best—perhaps the only—available hedge against inflation. Consequently, historically high mortgage interest rates have done little to dampen the demand for housing. Private housing starts were running at an annual rate of nearly 2.1 million units in September, continuing the two million-plus rate of starts generally maintained since July of last year. The high rate of permits for new residential buildings issued in September suggests a continuation of brisk construction activity for a while longer.

There appears to be little evidence of speculative fever in the business sector. With memories of the painful recession of 1973-75 still vivid, most firms have continued to maintain a relatively cautious approach to investment decisions. Inventories have generally been well aligned with sales, except in some retail lines where stocks appear to have been on the high side through much of the summer. Characteristic of the current business expansion, orders were cut back quickly when the growth of retail sales slackened for a time in the spring. Hence, production of consumer goods barely inched upward from April through September.

Production of business equipment and defense and space equipment, by contrast, continued to rise strongly through the summer. Thus, even with very sluggish growth of consumer goods output, capacity utilization in the manufacturing sector as a whole climbed to 85 percent by September, well within the range that historically has stimulated substantial investment in new productive facilities. New orders for nondefense capital goods did rise sharply in August after fluctuating around a plateau for six months. Construction contracts for commercial and industrial buildings also are substantially above year-ago levels. On balance, it appears that capital spending will continue to be a source of strength to the economy for some time to

Economic growth continued in the third quarter, although at a slower pace.



Gross national product is expressed as annual rates of change in 1972 dollars, seasonally adjusted

Source United States Department of Commerce, Bureau of Economic Analysis

come, but no real boom is in prospect.

Signs of the third-quarter slowing in the rate of economic growth were clearest in the labor market. According to the survey of households conducted monthly by the Bureau of Labor Statistics, there was virtually no net growth of employment from June to September, following the addition of 2.2 million persons to the employment rolls during the first six months of the year. Unemployment in September represented 6 percent of the civilian labor force. After peaking out at 9.1 percent in early 1975, the unemployment rate had fallen to 6 percent last April and has been fluctuating narrowly about that level ever since. While this rate is rather high by historical comparison, it is generally recognized that demographic and social trends, together with liberalization of various income maintenance programs, have tended to raise the overall rate of unemployment associated with any given degree of tightness in labor markets. In fact, reports of shortages of particular skills have been on the rise. The economic expansion appears to have entered the zone where inflation, formerly growing mainly out of structural and expectational factors, is now being sustained by aggregate demand pressures in some areas of the economy.

The news on the price front certainly has not been heartening. To be sure, the rate of overall price increase did slow during the summer as everyone had expected. The broadest measure of prices—the implicit price deflator for gross national product—rose at an annual rate of 7 percent in the third quarter, compared with 11 percent in the second. The improvement was centered in food prices. Retail food prices rose only slightly during the summer, after surging upward at an annual rate of 18 percent during the first half of the year. The relief for the consumer may well be only short-lived, however. Producer prices of finished food products rebounded sharply in September, and prices of both crude and intermediate food products also posted large increases. Outside the food sector, prices have shown little sign of moderation. Consumer prices of nonfood goods and services continued to rise in July and August at an annual rate in excess of 8 percent—in line with the experience of the first half of the year. And producer prices of crude industrial materials continued to soar at double-digit annual rates during the third quarter.

On the other hand, the rate of increase in wages may have slowed somewhat. Average hourly earnings of production and nonsupervisory workers in the private nonfarm business sector, adjusted to remove the effects of overtime in manufacturing and of shifts in employment among industries, increased at an annual rate of about 6½ percent in the third quarter, compared with 8½ percent during the first six months of the year. As stressed in the commentary that begins on page 1, a sustained moderation in the growth of wages would be highly auspicious for the outlook for controlling inflation. While there is room for optimism on this score, there are some imposing obstacles to moderation of labor costs. The price inflation that has already occurred will trigger automatic wage increases for millions of workers covered by cost-of-living agreements (COLA) in collective bargaining contracts (see the article beginning on page 16). Many more workers, both union and nonunion, who are not protected by a formal COLA will be granted wage increases in response to the ongoing rapid rise in the cost of living. The boost in the minimum wage scheduled to take effect on January 1, 1979 will push up the wage structure The increase in the social security tax rate and base, also scheduled to take effect at the beginning of 1979, will further raise costs of production by increasing payroll taxes on employers. Perhaps most importantly, a number of major collective bargaining agreements will come up for renegotiation in 1979. The degree of moderation shown in these forthcoming settlements will figure heavily in the outlook for inflation over the next three years. The President's program is in large part aimed at this particular problem.