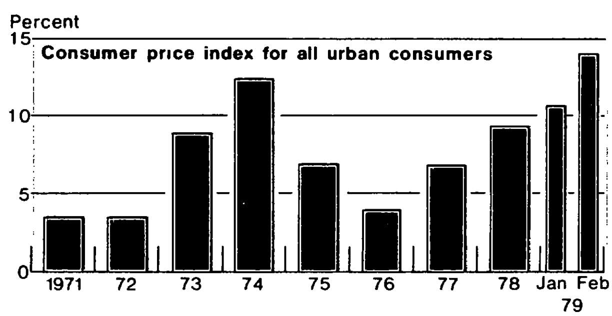
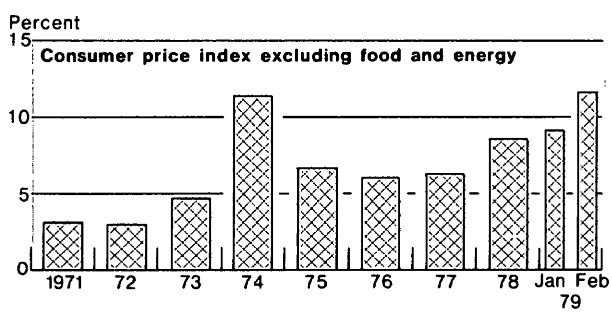
The business situation
Current developments

Chart 1

Inflation accelerated in early 1979 . . .



. . . even disregarding food and energy prices, which were subject to special influences.



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 seasonally adjusted annual rates

Source United States Bureau of Labor Statistics Index excluding food and energy calculated by Federal Reserve Bank of New York

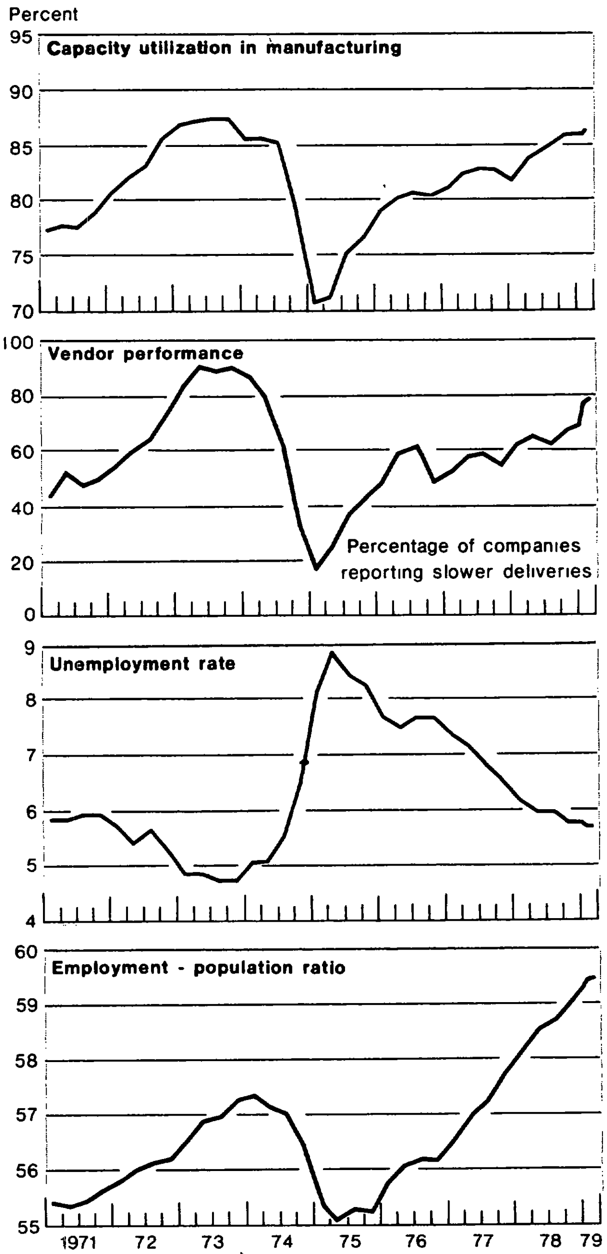
Inflation flared up in early 1979 with an intensity not felt since 1974. Some of the largest price increases were related to special circumstances, such as disruptions of food supplies by severe winter weather and the sharp increases in prices of imported petroleum imposed by the Organization of Petroleum Exporting Countries (OPEC). Moreover, fears of mandatory price controls may have prompted some increases in posted prices More fundamentally, however, the acceleration of inflation across a wide variety of goods appeared to reflect the confluence of demand pressures and supply constraints typical of the advanced stages of an economic expansion.

The acceleration of inflation actually began last year, when the consumer price index for all urban dwellers rose 9 percent, compared with increases averaging just over 6 percent annually during the three preceding years The pace of inflation quickened further early this year, with the consumer price index rising at annual rates of more than 10 percent in January and February (Chart 1). Prices of food rose especially sharply during the winter, reflecting both temporary consequences of supply disruptions related to severe winter weather and also the longer run upward trend of beef prices as the slaughter continued to decline. Consumers were also hit hard by sharply rising gasoline and heating fuel prices in the wake of the curtailment of petroleum supplies from Iran and the subsequent large increases in oil prices by the oil-exporting countries. Increases were more moderate for the broad range of other finished goods and services, but those increases—taken as indications of the underlying rate of inflation—also were distinctly higher than in 1978.

Some more recent price developments may contain

Chart 2

Shrinking Margins of Unused Productive Capacity



Data for 1979 are plotted monthly, 1971 through 1978 plottings are quarterly

Sources Board of Governors of the Federal Reserve System, Purchasing Management Association of Chicago, and United States Bureau of Labor Statistics

a glimmer of hope for the consumer. Thus, while producer prices of finished food products rose rapidly again in March, prices of both crude foodstuffs and intermediate food products edged up only slightly further following extremely large increases during the two preceding months Spot prices of various agricultural goods traded on commodity markets have been declining over the past several weeks as well. These price developments in transactions at the earlier stages of production may well presage some moderation of the rate of increase in retail food prices during the spring. Producer prices of finished goods other than food and energy also advanced more slowly in March than earlier in the year.

Unfortunately, this development may not signal a downturn in the underlying rate of inflation. The economy is presently operating with a limited unused productive capacity available to satisfy increased demands for goods and services (Chart 2). The rate of capacity utilization in manufacturing, at 86.3 percent in March, was less than 2 percentage points below the rate at the last cyclical peak in 1973, according to the Federal Reserve index. Indeed, among the advanced processing industries, factories were operating in March at very close to the 1973 peak. In the primary processing industries—where most of the bottlenecks occurred in 1973 and 1974—the rate of capacity utilization in March was still substantially below the 1973 peak. However, the explosive rise in energy prices since late 1973 has rendered some productive processes and facilities obsolete, or at least inefficient Consequently, economically viable capacity may be less than the indexes indicate. Strains on productive capacity are being reflected in some stretching-out of delivery times. For instance, a larger percentage of the companies responding to the monthly survey of the Purchasing Management Association of Chicago reported slower deliveries from suppliers in March than at any time since early 1974.

Constraints are more evident in the market for labor as well. The unemployment rate of 5.7 percent in the first quarter of 1979 was lower than at any time since the middle of 1974. To be sure, much lower rates have been attained in the past. However, demographic and social trends, together with liberalization of various programs for income maintenance, have tended to raise the level of unemployment rates associated with any given degree of tightness in labor markets. Significantly, the proportion of the working-age population with jobs rose to a post-World War II record in the first quarter. It is thus not surprising that reports of scarcities of skilled workers have become increasingly frequent in recent months, side by side with very high rates of unemployment for the unskilled, and particularly for the minority, urban young.

The overall demand for labor remained strong in the first quarter, despite indications of at least a temporary softening of demand in a number of sectors. Total civilian employment rose at a seasonally adjusted annual rate of 4.2 percent, matching last year's unusually rapid growth rate. Nevertheless, the growth of total output as measured by real gross national product (GNP) slowed to an anuual rate of only 0.7 percent, compared with the 4 percent growth registered in 1978. At least part of the slowing of the growth of economic activity resulted from disruptions caused by severe winter weather in various parts of the nation. This was most notably true in construction activity, where state and local government projects were curtailed and private housing starts plummeted in February to the lowest level since the middle of 1976. But bad weather also affected industrial production, factory shipments, and retail sales—all of which rose only slightly over the first two months of the year. The pattern of developments suggests that productivity moved sharply lower. While that quarterly movement cannot be taken as a harbinger for 1979 as a whole, it follows two years of exceptionally low productivity growth that contributed to inflationary pressures.

While the growth of final sales was slowing in the first quarter, inventory accumulation apparently increased, especially at wholesale merchants and manufacturers of durable goods. To some extent, book values of inventories were inflated by rapidly rising prices. To the extent that adverse weather affected shipments more than production, some of the inventory investment was probably unintentional. The decline in retail inventories in February, which occurred in spite of very sluggish sales, suggests that slow deliveries were responsible for some of the buildup of stocks at factories and wholesale outlets. There was also undoubtedly some deliberate rebuilding of stocks after the surge in sales during the closing months of last year. Some of the buildup probably represented a hedge against the possibility of a work stoppage in the trucking industry, which came to pass on the first eleven days of April. Finally, the possibility cannot be ruled out that some part—probably a very small part—of the January-February inventory bulge reflected a relaxation of the cautious attitudes that have governed inventory policies of most businesses throughout the current economic expansion.

By March it looked as though the economy was recovering from the winter doldrums. Retail sales posted a sizable advance in current dollars at least. Sales were especially brisk in furniture, apparel, and smaller domestic and imported automobiles. Industrial production advanced vigorously in March, with sizable gains widespread among products and materials, especially motor vehicles and parts, steel, and coal. Nonfarm payroll employment posted another large increase. Housing starts recovered but remained well below the levels of last year.

These developments, in themselves, may merely represent a rebound from two months of less buoyant activity rather than presage new demand pressures. On the other hand, new orders received by manufacturers of nondefense capital goods, especially aircraft, rose strongly in January and February, suggesting continued growth of capital spending. But the present uncertainties in the outlook for total demand may persist for some time.

In any event, supply limits are increasingly constraining gains in output after the exceptionally rapid rise in the final months of 1978. In the circumstances, strong new demand pressures could have unfortunate consequences for cooling the inflationary surge and for future orderly growth which must be weighed against the risk of some falling away from present levels of activity.