

# Review and outlook: 1978-79

## *Business: a time of test ahead*

Large gains were made in 1978 for the third consecutive year in employment, output, income, and retail sales. Momentum was so strong at year-end that some forecasters were modifying their predictions that a recession was imminent. Again, the economy had shown unexpected staying power in the face of adversity.

If activity continues to increase through March, as most observers expect, the expansion will have passed its fourth anniversary—remarkable longevity compared with past expansions. But a critical period of testing is certain in the coming months. Signs of strain can be seen in several areas.

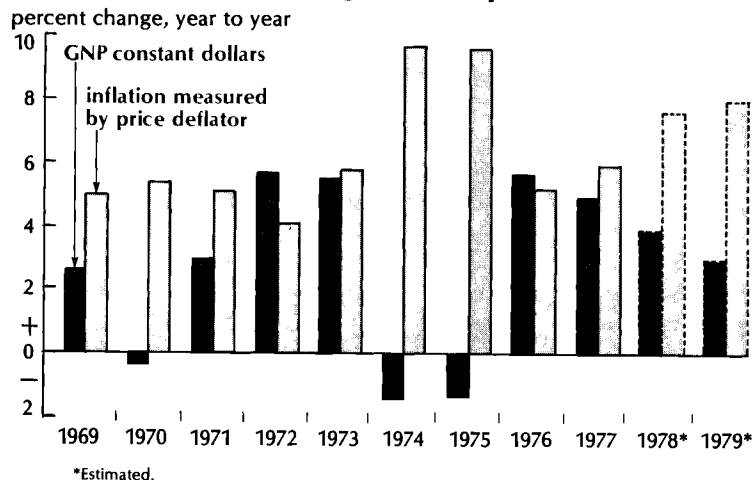
- Interest rates are at (or near) historical highs and credit markets are taut.
- Consumer debt burdens have climbed to an unprecedented level.
- Pressures have mounted to restrict government taxing and spending.
- A huge deficit persists in the balance of trade.
- The adequacy of oil supplies is again in question.
- Efforts to curb inflation through guidelines and budget stringency suggest disruptive conflicts among powerful sectors.

All of these problems arise from the fact that effective demand exceeds the nation's resources. The excessiveness of demand is reflected in continued inflation, the international trade deficit, and pressures on available facilities, materials, and labor. A start toward resolution of the problem of excess demand requires moderation of competing, and therefore conflicting, demands.

### A broad perspective

The gross national product reached \$2.1 trillion in 1978. That was an increase of almost 12 percent, compared with 11 percent in both 1976 and 1977. Forecasts made early in the

### More inflation and less growth expected for 1979



year proved optimistic. Price inflation was significantly underestimated, and real growth was overestimated. Inflation at about 7.5 percent was well above price increases of 5 percent in 1976 and 6 percent in 1977. Probably less than 4 percent, the real gain in output was well below the 6 percent reached in 1976 and 5 percent in 1977.

Two developments early in the year helped account for the year's performance being poorer than expected. One was the severe cold, high winds, and heavy snows that hampered transportation and production. The other was a 111-day strike by Eastern coal miners that sharply reduced coal supplies, forcing some utilities and steel mills to curtail output.

As in early 1977, when severe weather and natural gas shortages slowed activity, the economy snapped back as soon as normal conditions returned. Lack of growth in real GNP in the first quarter, nevertheless, interrupted a procession of 11 consecutive quarterly increases. The rate of price increase accelerated sharply in the second quarter but moderated after midyear.

Consumer outlays rose 11 percent, about in line with the rise in after-tax income and somewhat less than the rise in nominal GNP. Construction and spending on business equipment increased significantly faster than GNP. Government expenditures increased less than GNP, mainly because federal outlays fell short of the spending budgeted.

A recession is usually defined as a significant decline in real GNP for at least two consecutive quarters. The declines usually center in plant and equipment, inventory investment, housing, and consumer durable goods. Government spending and consumer purchases of nondurables and services usually rise even in a general slump.

Plant and equipment spending seems headed for a good year. Inventories are generally well balanced but could be vulnerable if final sales falter. Housing, which was still strong in 1978, is almost certain to decline in 1979. Consumer purchases of durables, which were at a high level in 1977 and 1978, are generally expected to soften.

## Consumer spending remains strong

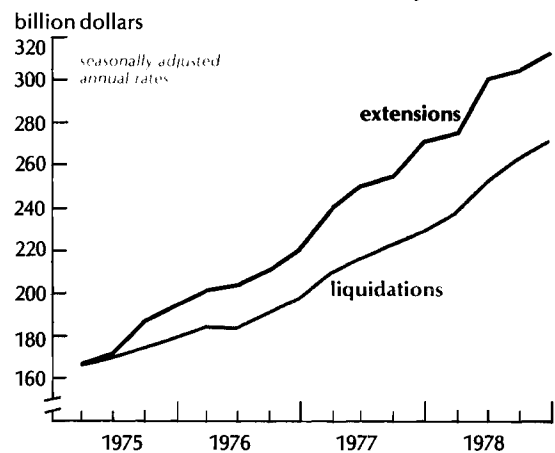
Despite surveys suggesting widespread apprehension, consumers continue to spend at a high rate. Total consumption spending rose about 11 percent last year. That was the same rate of increase as in 1976 and 1977.

Outlays on goods—both durables and nondurables—rose 10 percent. Outlays for services—including medical care, rent, and recreation—rose about 12 percent, marking continuation of a trend for services to account for a growing share of consumption. In 1978, 15 percent of consumption spending went for durables, 39 percent for nondurables, and 46 percent for services. Ten years before, less was spent on services than on nondurables.

Disposable personal income (DPI), income from all sources less taxes, rose more than 11 percent last year. That was the biggest rise since 1973. Savings (DPI less consumption) advanced in step, but as a proportion of DPI, held at about 5 percent. Though roughly the same as in 1977, that was down from almost 6 percent in 1976 and an average of 7.6 percent for 1972-75.

Reflected in the comparatively low rate of savings was continued heavy use of instalment credit. Gross extensions of instalment credit totaled \$300 billion last year, 18 percent more than in 1977, when extensions increased

## Consumers borrowed heavily



20 percent. Credit outstanding at year-end totaled \$273 billion, \$42 billion more than a year before and only slightly less than the rate of rise in 1977.

For the past two years, the rise in outstanding instalment credit has been more than half as much as personal savings. That has been unprecedented since World War II. Consumers have also been using mortgage credit increasingly to finance consumption spending.

Total car sales of 11.3 million, including 2 million imports, were only slightly below the 1973 record. Including trucks, vehicle purchases reached a new high. About 70 percent of all sales were financed. More than half of the new car loans last year were for more than 36 months. They were mostly for 42 or 48 months, but some carried even longer maturities. Car loans for more than 36 months were rare as recently as 1974.

Of the various types of instalment credit, use of bank cards, a handy substitute for cash, has increased fastest. About \$40 billion was extended on bank card credit last year, 30 percent more than in 1977. Outstandings at year-end approached \$18 billion, again an increase of about 30 percent.

New debt instruments, changes in consumer attitudes, and the structure of

household income cast doubt on assertions of some analysts that consumers generally are over-extended. The Survey Research Center at Ann Arbor has stated that analysis of consumer opinions reveals that fears of inflation, which once caused consumers to hold back on nonessentials, now seem to be stimulating spending.

More couples now have two incomes and no children or old folks to provide for. Most people expect their income to rise year-by-year, often through automatic indexation, and retirement income to be provided. They are often well protected against the contingencies of sickness and disability. Under these circumstances, the concept of discretionary income takes on new dimensions.

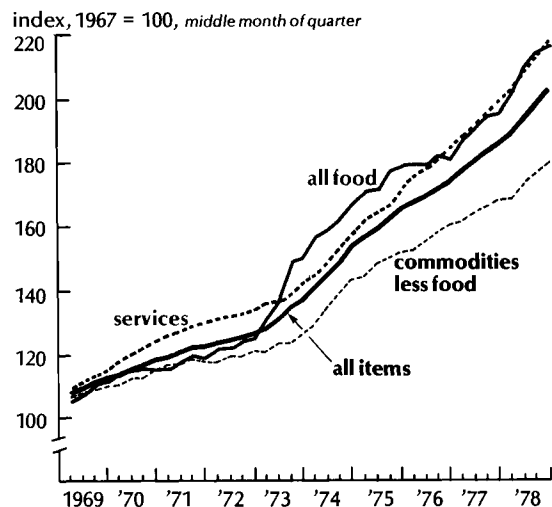
### Consumer prices

The Consumer Price Index (CPI) averaged 7.7 percent higher in 1978, following increases of 5.8 percent in 1976 and 6.5 percent in 1977. After the record 11 percent rise in 1974, the rate of increase slowed in 1975 and 1976, giving unfounded hope that inflation was on the wane.

Monthly trends show an even darker inflation picture. In December, the CPI was up 9 percent from a year before. That was for all types of consumer purchases. But prices of food for use at home were up 12 percent, home ownership up 12 percent, medical care up 9 percent, fuel up 8 percent, and transportation up 8 percent. Apparel prices, which have been held down by a heavy influx of foreign clothes, were up 3 percent.

Part of the record rise in the CPI in 1974 could be attributed to special factors—the sharp increase in energy prices after OPEC boosted oil prices, poor crops, and the end of price controls. No special factors can be blamed for the acceleration of prices in 1978. A multitude of forces are working either to increase money income, reduce supply, or both. These include, for example, automatic cost-of-living adjustments (COLA), more liberal unemployment compensation policies, environmental regulations, government farm programs, restrictions on imports, the

### Consumer prices accelerated



higher minimum wage, higher Social Security taxes, the depreciating value of the dollar abroad, and subsidies for rent, food, medical care, and transportation.

### **Wage and price guidelines**

The Administration has insisted it does not favor mandatory wage and price controls. The program in effect from August 1971 to April 1974 is generally believed to have done more harm than good. Many observers have pointed out that interference with the functioning of the market system leads to misallocation of resources, shortages, black markets, and over the long run, more inflation than if controls had not been imposed.

On October 24, the President announced a program of **voluntary** guidelines to slow inflation. He urged that increases in compensation, including fringe benefits, be held to 7 percent, not for every individual, but on average for groups of workers. He also urged that price increases—here, too, the average for all products of a company—be held to half a percent less than the average annual increase for 1976-77. The guidelines do not apply to farm products or imports. A profit margin test will be applied, however, to food processors and retailers and others with special problems.

Under this program, the Council on Wage and Price Stability will require reports from large corporations, especially the 500 largest with annual sales of more than \$500 million, for use in determining whether the companies are complying with the guidelines. Companies believed not to be complying will be barred from government contracts if the goods or services they provide can be obtained elsewhere. This holds even if the companies are potentially low bidders.

Various large companies have announced they will cooperate with the guidelines. In most cases, they say the proposed regulations are flexible enough for them to comply without undue interference with their operations.

Some labor leaders have said their unions will cooperate. Others have denounced the

proposals as unfair. Major tests will come in the months ahead. The trucking industry pacts expiring in March are deemed particularly significant.

### **Labor negotiations ahead**

In the first five months last year, first-year wage increases negotiated in major labor contracts averaged 7.7 percent, about the same as in 1977. First-year increases in total compensation, including pensions, health insurance, and other supplements, averaged 8.8 percent, somewhat less than in 1977 but clearly well above the guideline.

Some labor unions, those representing coal miners, railroad workers, and machinists, for example, have recently negotiated contracts for increases of 30 percent or more over a three-year period. Administration spokesmen say no effort will be made to challenge contracts already negotiated for fixed future increases. Moreover, new contracts will not be opposed if they match increases in other contracts, provided there is a traditionally “tandem” relationship between the workers.

The labor bargaining calendar was light in 1978, both in terms of the number of workers covered (1.8 million) and the types of unions involved. This year, the “heavy hitters” will come up to bat. Altogether, over 3.7 million workers are involved, including those in the oil industry (January), trucking (March), rubber (April), electrical equipment (June), and autos, farm and construction equipment (September). Most of these groups had increases in compensation in 1976 in excess of the average in contracts negotiated in that year.

### **Labor costs and productivity**

Hourly compensation per worker in the private economy, including employer contributions for Social Security, rose over 9 percent last year, somewhat above the average for the previous five years. In the late 1960s and early 1970s, increases had averaged about 6.5 percent, up from 4 percent in the early 1960s.

Improved efficiency reflected in increased productivity (output per worker hour) helps hold down prices. If increases in productivity matched increases in worker compensation, unit labor costs—the main element in total costs—would be stable. Pressures on prices would be minimized.

In the 25 years 1947 through 1972, productivity for the entire private economy rose an average of 3 percent a year. Since 1972, increases have averaged only about 1 percent. Last year, there was little or no rise in productivity.

With compensation rising 9 percent a year for the past five years and productivity increasing only 1 percent, labor costs per unit of output have increased about 8 percent a year. Prices in the nonfarm economy increased about the same pace.

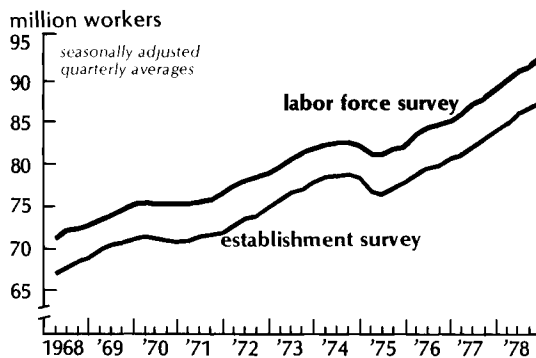
The reasons for the sluggish trend in productivity are not entirely clear. The 1974-75 recession, increased government regulation, unusually severe weather, an inadequate level of investment in modern labor-saving equipment, inadequate training of younger workers, and a rise in the proportion of total output originating in the service industries (where productivity is lower than in the goods-producing industries)—all these have played a part. But one thing is certain. The gap between increases in compensation and increases in productivity will have to narrow before progress can be made against inflation.

### Employment and unemployment

One of the salient features of the business expansion that began in the spring of 1975 has been the rapid rise in employment. Employment totaled almost 96 million in December, up 3.3 million from a year earlier and 10 million from the cyclical peak of 1974. The rise has been unprecedented.

Except for agriculture, where the trend is still downward, all major types of employment have increased substantially in the past three and a half years. Proportionately, the biggest gains have been in the trade and service industries. All five states of the Seventh

### Employment rise has been unprecedented



Federal Reserve District report large gains in employment, though only in Wisconsin has the pace matched the national surge in employment led by the fast-growing states of the South and West.

Unemployment remained at the 6 million mark last year. That was slightly less than 6 percent of the civilian labor force, which was almost 102 million in December. Unemployment tends to be concentrated among young workers and minority workers.

Over 59 percent of the population over 16 years old held jobs in December. That was a record proportion, up from 58 percent in December 1977 and 56 percent in December 1976. Reflected mainly in the higher job-to-population ratio was the increase in the number of women workers. Women now make up 41 percent of the labor force, compared with 36 percent a decade ago.

### Manufacturing leads GNP

While real GNP rose 4 percent last year, manufacturing output increased about 6 percent, the same as in 1977. After a drop in January associated with bad weather, manufacturing output rose steadily throughout the rest of the year. Large order backlogs for durable goods suggest that the uptrend could continue well into 1979.

In December, the Federal Reserve's index of manufacturing output, measured in physical units, passed 151 (1967=100), rising to

a level 8 percent higher than a year earlier. Nearly all types of manufacturing participated in the rise, but business equipment was the star performer. Output of business equipment was 10 percent higher than in December 1977, compared with an increase of 3 percent for the production of consumer goods.

The motor vehicle industry turned in another strong performance. It produced 9.2 million passenger cars, about the same number as in 1977. The record was set in 1973, when 9.7 million cars were produced. The industry produced 3.7 million trucks. That was a new record, 7 percent more than the previous high set in 1977. Many of the smaller trucks were bought for personal use. Plants producing trucks operated close to capacity all year. Demand for four-wheel drive vehicles and heavy-duty trucks was especially strong.

Demand for farm equipment was weak early in the year, when farm prices were low and farm income depressed. But sales began improving rapidly in the spring, and production schedules were stepped up. Inventories of farm equipment were low in December, compared with a year earlier.

Steel shipments from domestic mills totaled 98 million tons last year, up from 91 million a year earlier but still well below the record 111 million tons shipped in 1973.

With the government moving to discourage below-cost sales of foreign steel here, imports had been expected to decline from the 19.3 million ton record set in 1977. Instead, they rose to a new high of 21.6 million tons. That was 18.4 percent of domestic supplies last year, another new high.

### Housing surprisingly strong

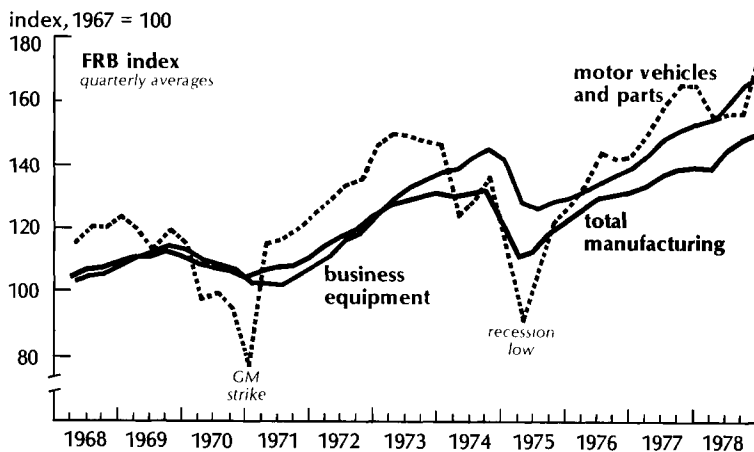
Because of high interest rates and a projected reduction in the availability of mortgage funds, housing starts had been generally expected to decline in 1978, dropping probably 10 percent or more. But about 2 million units were started, the same as in 1977 and a total substantially exceeded only in 1972, when there were 2.4 million starts. Sales of existing homes rose 9 percent from the previous record set in 1977 to a new high of 3.9 million. Prices rose 12 to 14 percent.

Starts and sales stayed high because mortgage credit remained available. Savings and loans, the main lenders on residential property, continued to receive large net inflows of funds. In previous periods of tight money, such as 1973-74, interest rate ceilings imposed by regulatory authorities prevented savings institutions from competing effectively for funds. The result was *disintermediation*, meaning investors turned to higher-yielding

money-market instruments, such as Treasury bills.

Several factors helped support the flow of mortgage funds in 1978. Beginning in June, S&Ls were allowed to offer six-month certificates of deposit in amounts of \$10,000 or more at yields as high as ¼ percent above the latest auction yield on six-month Treasury bills. Sales of these money-market certificates enabled S&Ls to maintain a large volume of funds to meet loan demand. Another factor was the sale

### Business equipment production outgained total manufacturing



of bonds secured by mortgages, mostly under federal guarantees. Still another was an easing up on usury ceilings. Various states, including Illinois and Iowa, had raised ceilings or made them more flexible in recent years.

At 1.4 million, single-family starts last year approached the 1.45 million record set in 1977. Construction of apartments was much more volatile, as it has been in recent years. About 600,000 multifamily units were started in 1978, 12 percent more than in 1977. But while the rate of multifamily starts was twice the depressed rate in 1975, it was still 40 percent less than in the boom from 1971 to 1973.

A major factor in the undertaking of multifamily projects has been the availability of federal subsidies. Subsidized multifamily starts reached about 200,000 in 1978, more than four times the starts in 1975. Despite low vacancy rates, unsubsidized apartment construction has been held back by rents that while rising, have not kept up with costs of construction and operation. Starts on condominiums and conversions of existing apartments to condominiums have picked up in the past two years. This has been mainly because of tax advantages to both buyers and sellers.

After holding near 9 percent from 1975 through 1977, interest rates on new mortgages averaged about 10 percent by late 1978. Buyers were willing to pay these rates because real estate has proven to be the best hedge against inflation available to most households. To acquire an equity interest in their house or apartment, people have been willing to devote more of their income to mortgage payments. The trend has been encouraged by the growing number of families with two incomes and often no children.

High rates on mortgage and construction loans, combined with slower growth in family income, are likely to dampen residential construction this year. But with the continued availability of credit and a strong rate of household formation, the decline can probably be held to no more than 10 to 20 percent this year, which is not nearly so steep as in past housing cycles.

## Capital expenditures and capacity

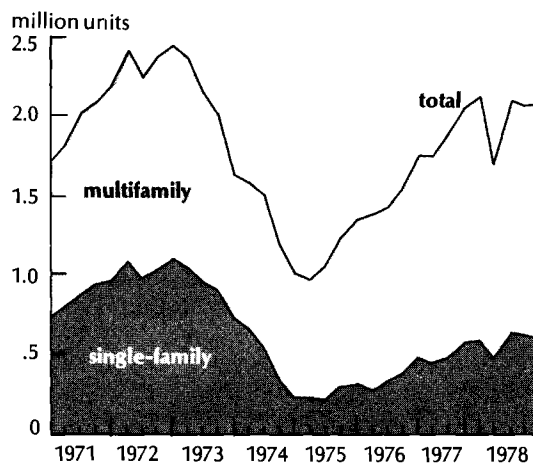
Business outlays on new plant and equipment have increased rapidly for three years. Spending increased 16 percent last year. After adjustment for inflation, the increase was about 8 percent. Capital outlays were 10.6 percent of GNP last year, a ratio surpassed only in 1966 and 1974 and then only slightly.

Surveys show business capital outlays are expected to rise again in 1979. Though the increase is apt to be somewhat less than in 1978, prospects for continued expansion in control spending are supported by large backlogs of orders reported by producers of capital equipment and by the heavy volume of contracts for nonresidential construction.

Orders have been particularly strong for machine tools, construction equipment, heavy trucks and trailers, railroad equipment, and commercial aircraft. F.W. Dodge reported that contracts for commercial buildings last year were 50 percent higher than in 1977. Contracts for manufacturing buildings were up 60 percent. Similar increases were reported for the Midwestern region. Much of this work will be put in place in 1979.

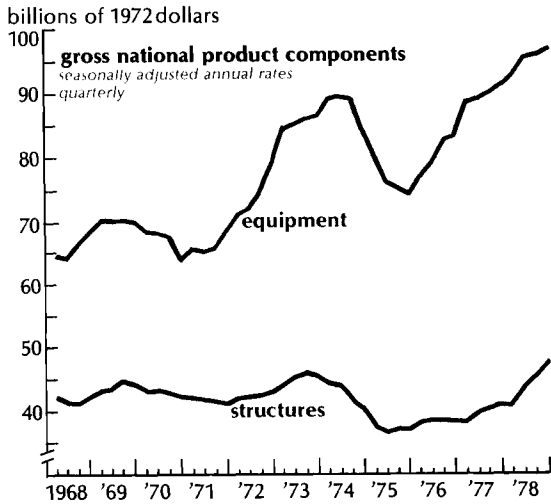
If the nation is to have a comfortable, prosperous future, capital outlays will have to

## Housing maintained high plateau



rise further. A large part of business outlays is going to alleviate pollution, promote health and safety, and comply with other state and federal regulations, rather than to improve

### Spending on business structures and equipment surged



efficiency or add to the capacity to produce goods and services. Large additional outlays are also going to ensure adequate supplies of increasingly expensive energy and to conserve use of energy.

Demands on productive facilities, raw materials, and the experienced people in the workforce kept the nation's economy operating close to its effective capacity in 1978. Margins of unused resources are uncomfortably narrow in such important sectors as energy, transportation, steel, nonferrous metals, and building materials, including cement, brick, sheetrock, and insulation. Demand for technical and scientific skills substantially exceeds the number of trained people available for work.

Until the capital stock and pool of trained workers are raised appreciably, additional buying power created by higher incomes and expanding credit will not raise total output. Rather, it will be dissipated in higher prices. A healthy atmosphere for private capital formation is an essential ingredient for material progress.

### 1978 Annual Report

Limited copies of the 1978 Annual Report of the Federal Reserve Bank of Chicago are now available. The publication includes statements of condition and earnings and a summary of this bank's operations for 1978. Send requests to:

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