Review and outlook: 1976-77

Business: broad improvement continues

Despite widespread dissatisfaction with the performance of the U.S. economy in 1976, impressive gains were recorded in employment, output, personal income, and corporate profits. Unemployment remained at distressingly high levels, partly because of an abnormally large rise in the labor force. The rate of inflation slowed markedly. Interest rates moved lower during the year, contrary to expectations. Credit was more available in all markets, and liquidity improved in all sectors. The experience of the Seventh Federal Reserve District states—Illinois, Indiana, Iowa, Michigan, and Wisconsin—was broadly similar to that of the nation.

In the summer and fall the rate of economic growth slowed significantly from the pace set early in the year. In part, the "pause" could be attributed to an unplanned short fall in federal outlays, major strikes, and political uncertainties. In December, however, reports on retail sales, personal income, employment, production, and factory orders indicated that growth was accelerating again. Executives and economic analysts were in virtually unanimous agreement that the upswing would continue into 1977 and perhaps throughout the year.

Predictions and results

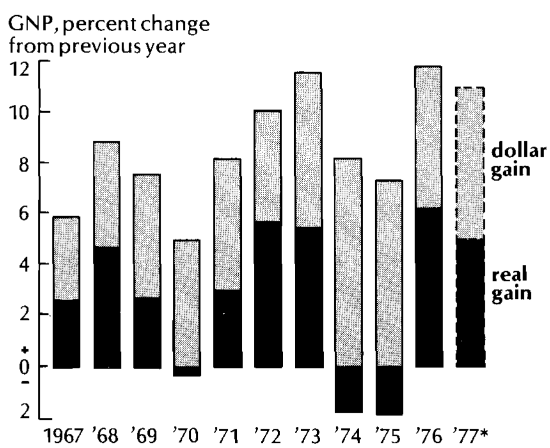
The performance of the U.S. economy is commonly judged by three major criteria:

1. *Growth*—the percentage change in the gross national product—total output of goods and services—adjusted for price inflation (real GNP).
2. *Inflation*—the percentage change in the general price level measured either by the implicit price deflator derived from the relationship between current dollar GNP and constant dollar GNP, or the consumer price index ("cost of living").
3. *Unemployment*—the number of jobless people seeking work expressed as a percentage of the civilian labor force.

In 1975 real GNP declined 2 percent for the second consecutive year, the price level increased 9 percent—slightly less than in 1974—and unemployment averaged 8.5 percent—up from 5.6 percent in 1974.

Early in 1976 virtually all forecasts called for significant improvement in the economy. On January 26, for example, the President's Council of Economic Advisers projected a rise

Outlook for further growth remains favorable



*Estimate.

in real GNP for 1976 of 6 to 6.5 percent, inflation at 6 percent, and average unemployment at 7.7 percent. These estimates were close to the "standard" or typical forecast. It now appears that in 1976 real GNP rose slightly more than 6 percent; inflation was just over 5 percent measured by the implicit deflator, and less than 6 percent measured by the consumer price index; and unemployment averaged 7.7 percent.

Economic results for 1976, taken as a whole, were quite close to predictions. However, most observers had expected the improvement to continue through the year at a fairly steady pace. Unfortunately, this did not occur.

Inventories and capacity

The upswing was very rapid in the first quarter of 1976 as real GNP increased at an annual rate of 9 percent. A major factor in this surge was the shift in inventory investment. In constant dollars inventories were liquidated at an annual rate of $6 billion in the fourth quarter of 1975. In the first quarter of 1976 inventories were accumulated at a $10 billion rate. This development reversed the experience of a year earlier when inventory accumulation at a rate of $9 billion in the fourth quarter of 1974 changed abruptly to liquidation at a rate of over $20 billion in the first quarter of 1975.

When inventories are declining production falls below current consumption. When inventories are rising production exceeds consumption. This phenomenon has figured prominently in every business fluctuation since World War II. The 1974-76 experience may be unique in the great variety of products affected, both hard and soft goods lines.

Inventory accumulation continued throughout 1976 for business taken as a whole, but the rate of accumulation of the first quarter did not accelerate.

In the spring rising shipments caused order lead times to lengthen for many products. Some purchasing managers feared a reappearance of the shortages that disrupted output schedules in 1973 and early 1974 and increased orders accordingly. During the summer it became apparent that fears of near-term shortages were groundless and orders for many products were cut back. Inventories of some products such as steel, textiles, appliances, and chemicals were reduced. These developments played a large role in the slowing of the rate of rise in real GNP. "Final sales," GNP less the change in inventories, continued to rise quarter-by-quarter at a fairly steady pace.

Predictions favorable again

Economic forecasts for 1977 indicate that the year ahead will closely resemble 1976. Once again the range of predictions is remarkably narrow.

Business Week, in its year-end issue, published a compilation of forecasts for 1977 by 25 individual economists and nine econometric models. The average of these forecasts shows a rise in real GNP of just under 5 percent with a range from 4.2 to 5.8 percent. Prices are expected to increase 5.5 percent with a range from 4.5 to 7.3 percent. Unemployment is expected to average 7.2 percent with a range from 6.7 to 7.6 percent. The spread between the high and low forecasts is not inconsiderable, but even the extremes provide little advice for individual executives beyond the notions that (1) the year will be fairly prosperous, (2) full employment will not be regained, and (3) inflation will continue at a high rate relative to historical standards. Within this scenario variations in results among industries and among firms within industries no doubt will be large.

In the past 30 years the annual rise in real GNP has averaged 3.5 percent. Growth was the result of an average annual rise of 1.5 percent in employment and a 2 percent average rise in output per worker. In the past decade the labor force has increased over 2 percent per year. Assuming that productivity gains continue at the historic rate, it appears that growth in real GNP must average about 4 percent per year to keep unemployment from rising. This rate of growth was exceeded in 1976 and probably will be again in 1977.

However, the economy is operating well below its potential.

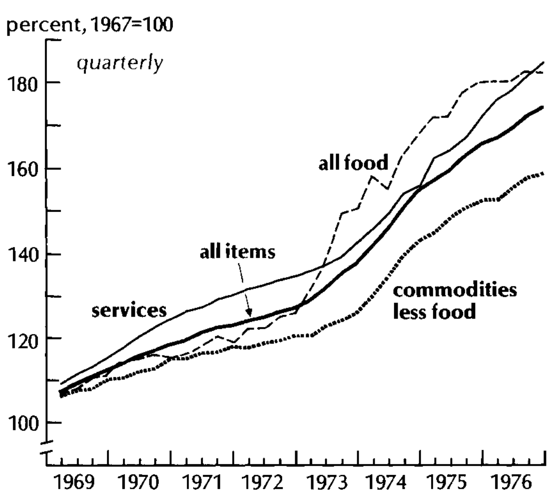
Consumers spend freely

Most observers judged that consumers did their part in promoting prosperity in 1976, in contrast to the sluggish trend in business investment. Personal income rose almost 10 percent, compared to 8.4 percent in 1975. Wage and salary income increased slightly more than 10 percent, almost twice as much as in 1975. Disposable income rose 9 percent, compared to 10 percent in 1975 when taxes were reduced.

Consumer spending on goods and services increased somewhat faster than disposable income in 1976. Total retail sales rose 11 percent, and outlays on services, including rent, rose slightly more. Personal savings, disposable income less personal outlays, declined slightly and the ratio of savings to disposable income declined from 7.8 percent to about 6.5 percent, lowest in four years. The decline in the savings rate partly reflected faster growth of instalment credit.

Retail sales of the automotive group rose 23 percent in 1976, while sales of other stores rose 9 percent. Aside from passenger cars, consumers sharply increased purchases of light trucks, recreational vehicles, furniture, television sets, other home electronics products, and certain appliances such as microwave ovens. In addition to goods, consumers increased spending substantially for services such as air travel (up 10 percent for the year), tourist attractions, insurance, rent, and tuitions.

Rise in consumer prices moderated



Consumer price rise slows

One of the most promising developments of 1976 was the reduced rate of inflation indicated by the Bureau of Labor Statistics' consumer price index. The importance of this index has increased year by year as additional labor contracts, pensions, and other contracts are "escalated" according to the changes it registers.

Consumer prices averaged 5.8 percent higher in 1976 than in 1975. This was the smallest rise since 1972, and substantially less than 9 percent in 1975 and 11 percent in 1974. Moreover, the rate of increase slowed further in the later months of the year. In November prices averaged only 5 percent above the year-earlier level.

In November food prices were up only 1 percent from the year before. This reflected a surprising 9 percent *decline* in meat prices. Other food items were up about 7 percent. Food prices had been a major factor in the very rapid price inflation of 1974-75. In the nonfood sectors especially large increases were posted last year for gas, electricity, insurance, and automobiles. With a reversal in the meat price decline highly probable, and most producers of goods and services beset by a squeeze between prices and costs, consumer prices are likely to rise somewhat more rapidly in 1977.

Analyses of the impact of wage contracts with cost-of-living adjustment clauses (COLA) typically assume that future increases in consumer prices will average 6 percent annually. Although 6 percent is only half as fast as the rise in prices in 1974, the worst inflation year, it is very rapid, compared to increases of about 1 percent annually in the early 1960s, judged in retrospect to be a period of relative price stability. Moreover, a 6 percent rate of price inflation compounded implies that the price level will double in 12 years.

Big rise in employment

In November total employment reached an estimated 88.1 million, up 4 million from the low of March 1975, and almost 2 million above the peak reached before the 1974-75 recession. Unemployment was estimated at 7.8 million in November, however, almost as high as in the worst months of 1975. High unemployment despite rapidly rising employment reflected an abnormally rapid increase in the civilian labor force.

The civilian labor force rose 3 percent in the 12 months ending in November, twice as fast as in the previous 12 months. When employment rises rapidly secondary workers are more likely to seek work if they learn that jobs are more available. In a typical month only about half of those seeking work *lost* their last job.

Nonfarm wage and salary employment was 79.7 million in November, up 3.3 million from the 1975 low, and about 1 million above the 1974 peak. As in past expansions manufacturing employment has lagged the general uptrend, when compared to earlier peaks. In November manufacturing employment was 19.1 million, up 1 million from the 1975 low, but still 1 million short of its high.

Employment in construction was 3.4 million in November, the same as a year earlier, as activity in nonresidential construction continued at a reduced level. Most service-producing sectors showed significant gains in employment in the past year, especially in retail trade.

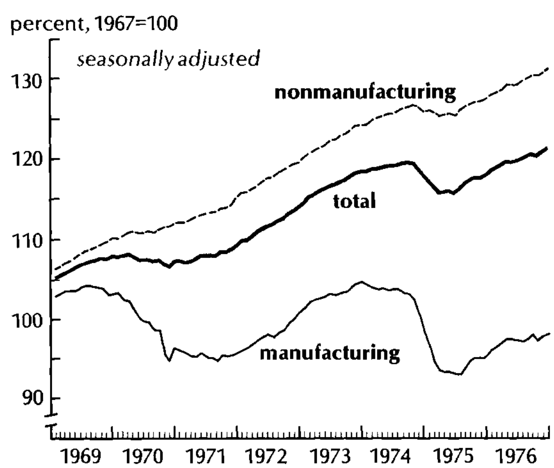
Employment increases in the Seventh District were somewhat less than in the nation, primarily because demand for various capital goods failed to revive significantly. However, unemployment rates in all district states were estimated to be substantially lower than in 1975.

Strong rise in manufacturing

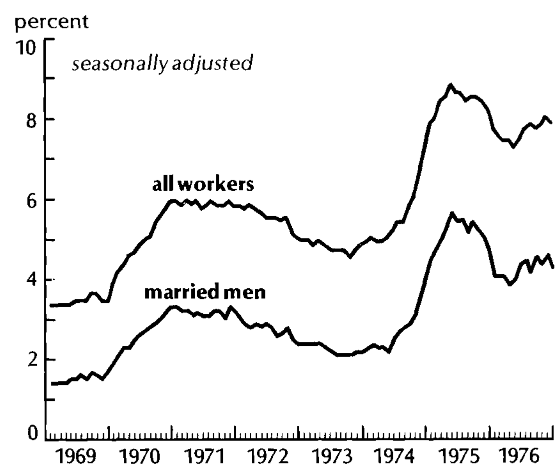
Factory output measured by the Federal Reserve's Industrial Production Index increased about 11.5 percent in 1976. This increase brought total manufacturing output for the year to a level almost exactly the same as in 1973 and 1974. Virtually all industries showed substantial gains last year. The broad categories of durables and nondurables each rose over 11 percent. Motor vehicle output was up 26 percent. Business equipment rose only 6 percent.

Manufacturing output declined 17 percent from September 1974 to March 1975, the

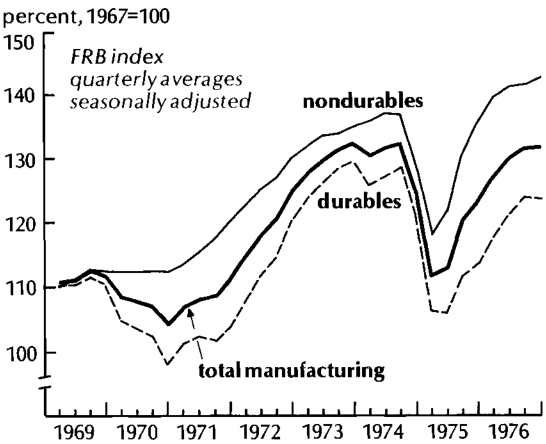
Payroll employment advanced to new record . . .



. . . but unemployment remained high



Manufacturing output neared 1974 peak



most severe drop since World War II. Durable goods declined 19 percent in this period. From the low point output rose for 17 consecutive months, although the pace of the rise moderated last summer. Output declined slightly in September and October because of inventory corrections and strikes. The November rebound regained this ground.

When manufacturing output declined last fall there were fears that further declines or at least a prolonged pause lay ahead. However, most major expansions have been interrupted in a similar fashion. This occurred in 1956, 1962, and 1967 when a pause was merely a prelude to a broad, sustained rise in activity. Factory orders increased late in the year, and most manufacturing executives anticipated further substantial gains in output.

Strikes hampered output

Labor disputes were more serious in 1976 in Midwest industries than at any time since 1970, the year of the long strike at General Motors. Most prominent were strikes in rubber, coal, motor vehicles, farm equipment, and parcel delivery service. In many cases agreements finally reached were more generous than business negotiators had anticipated when talks began.

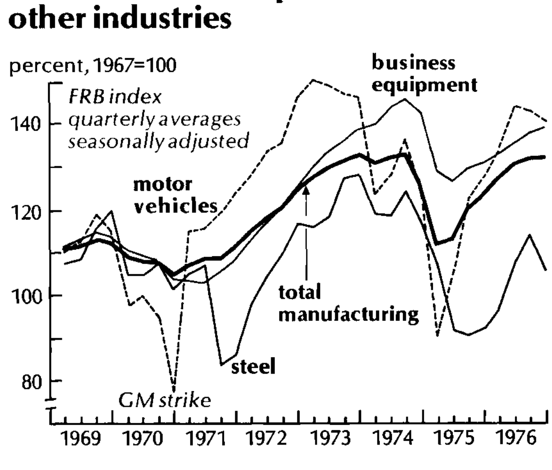
In the first nine months of 1976 the average new major labor contract resulted in first-year wage increases of 9 percent (although several were for 10 percent or more), compared to 10 percent in all of 1975. In addition, unions obtained additional benefits related to inflation protection, medical care, and pensions. Average increases in compensation for all workers were not far below the increases obtained in major labor contracts. Increased output per worker offset about half of the rise in compensation in 1976 for the private economy as a whole. Productivity gains usually are relatively large in the early stages of an expansion, but the rate of improvement tends to fall off rapidly as margins of unused capacity are narrowed.

In contrast to 1976 the coming year is expected to be characterized by relative peace in labor-management negotiations. No major deadlines will occur until July (electrical and communications) and August (steel). Moreover, the patterns established by the major settlements of 1976 probably will provide guidelines for 1977.

Steel demand disappointing

In the spring of 1976 steel analysts forecast that shipments to users and service centers would total 95 to 98 million tons for the year, compared to 80 million tons in 1975, and a record 111 million tons in 1973. For a

Motor vehicles outpaced other industries



time in the spring it appeared that the upper range of the forecasts would be reached or exceeded. Delivery times on flat-rolled products lengthened significantly and there were predictions of widespread shortages of various steel products late in the year.

Expectations of high operating rates in steel envisaged a buildup in inventories by steel users. When it became apparent that steel capacity was ample to satisfy current demands many steel users took steps to *reduce* inventories. In addition, heavy construction and output of capital goods and certain other products fell somewhat short of expectations. Finally, imports increased significantly. As a result, output of raw steel declined 25 percent from a peak in late May to a low point in late November. Steel output increased in December.

A price increase for flat-rolled steel scheduled for October 1 was rescinded when steel users cut orders sharply. As orders revived in November, however, a 6 percent increase in prices was put into effect on December 1.

Steel shipments actually totaled only about 90 million tons in 1976. With inventories back in line and a further increase in total consumption expected for 1977, steel shipments are expected to rise to 100 million tons, a level probably well within the capacity potential of the industry.

Automobiles and trucks

Sales of passenger cars totaled just over 10 million in 1976, including about 1.5 million imports. This was up 16 percent from 1975, but well below the 1973 record of 11.4 million. Sales of trucks totaled 3.2 million, including 240,000 imports. Truck sales were up 27 percent and approximated the 1973 record. Sales of both cars and trucks probably would have been somewhat larger, but for the 30-day strike at the Ford Motor Company.

Demand for small cars, compacts and subcompacts, was much reduced. Imports, almost all small cars, accounted for less than 15 percent of the U.S. market, down from a record proportion of over 18 percent in 1975. Production schedules for U.S.-built small cars were reduced several times. By contrast, sales of intermediate- and large-size cars were generally excellent and various popular models were in short supply.

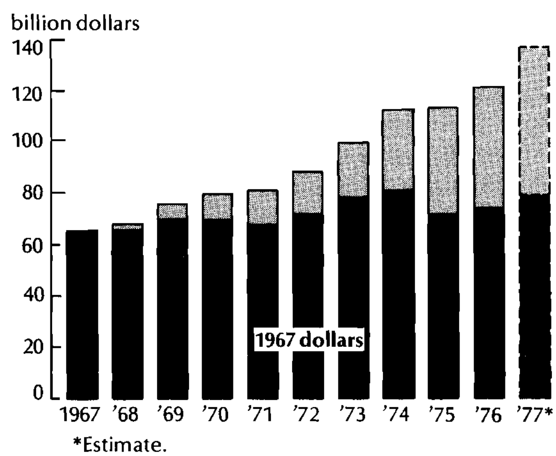
Sales of light trucks, perhaps 40 percent for personal use, were at record levels. Orders for large trucks and highway trailers also rose sharply, although they did not regain the high rate of 1974.

Motor vehicle production is expected to increase substantially again in 1977. General Motors, more optimistic than most, projects auto sales at a near record 11.25 million, and truck sales at a record 3.5 million. Major auto companies are planning large capital expenditures, mainly to improve efficiency and to meet federal standards to reduce emissions and to improve gas mileage.

Capital expenditures up slightly

Business expenditures for new plant and equipment located in the United States totaled $121 billion in 1976, up 7.5 percent from 1975, but up only 2 or 3 percent in real terms. The performance of the capital goods sector has been disappointing to most observers. In the third quarter real GNP was about 2.5 percent above the high reached in the fourth quarter of 1973, but real spending

Further gains expected for capital spending



*Estimate.

on nonresidential fixed investment was still 12 percent below the peak. This record compares unfavorably with earlier recoveries.

Among industries, airlines, railroads, and steel mills spent less in 1976 than in 1975. By contrast, public utilities, and the motor vehicle, food, oil, and paper industries increased spending more than the average. Most analysts expect capital spending to be up 5 to 10 percent in 1977 in real terms. Again, utilities, auto companies, and oil companies are expected to account for a large share of the rise, but all major categories of industry plan to boost outlays significantly.

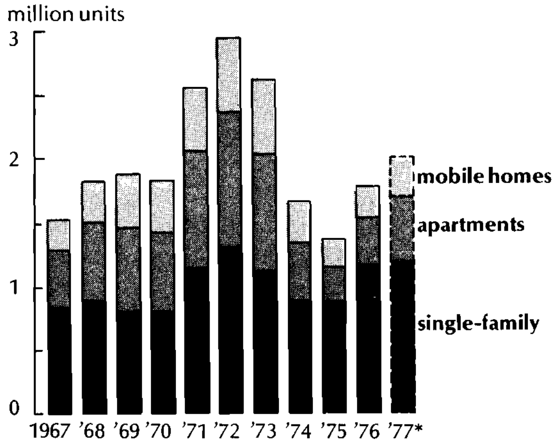
Optimism on capital spending for 1977 is supported by expected narrowing of margins of unused capacity, continued gains in corporate profits, improved business liquidity, ample availability of short- and long-term credit at rates lower than had been expected several months ago, and a slower rise in costs of construction and producer goods than in the 1973-74 boom. A crucial ingredient, however, is confidence on the part of business executives.

Home building leads construction

Early in the fourth quarter spending on construction was at an annual rate of $150 billion, up about 10 percent from the year-earlier level. After adjustment for cost increases, construction outlays were up about 4 percent. Outlays on new housing units were up about 25 percent in real terms, but nonresidential private construction was 2 percent below the reduced level of 1975, and public construction was off 10 percent.

Housing starts totaled over 1.5 million in 1976, up 30 percent from 1975, but well below the 1972 peak of almost 2.4 million. Single-family home starts, at 1.2 million, were fairly close to the 1972 level, but multifamily starts at 350,000, although up substantially from 1975, were only about one-third as many as in 1972.

Sharp upswing for single-family homes



*Estimate.

Easier credit terms, including lower interest rates, have helped to boost home construction in the past year. Sales of new and existing homes combined have been at record rates despite price increases averaging close to 10 percent. Apartment construction is still at relatively low levels because of a residual of vacant units resulting from overbuilding in the early 1970s. Vacancy rates have been declining, however, and higher rents justify more proposed projects.

The National Association of Home Builders has projected a rise in housing starts of 15 percent in 1977 to about 1.75 million units with increases for both homes and apartments. Expanded federal programs to build subsidized units might increase these totals. Some gains are expected also for commercial and industrial construction, but only to a limited degree. An overhang of unrented office buildings and stores is still reported in most areas, and industrial companies are emphasizing purchases of equipment relative to new construction.