

Fuel crisis hits business

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The economy reeled this summer from the impact of a series of adversities. The most important was the shortage of motor fuel resulting from the disruption of oil supplies from Iran. Others included truck strikes, the airline strike, labor pacts that exceeded Administration guides, soaring interest rates, further price inflation, and still lingering effects of the severe winter. Together, these blows brought an end to a four-year upswing, an expansion already creaky with age by historical standards. Belated recognition of the fact that oil shortages are likely to recur is having a profound effect on patterns of consumer spending, business investment, and real estate development. Rethinking of broad strategies means delays in decision-making and a more sluggish economy.

Real activity declined in the second quarter after a miniscule gain in the first. Inflation was running at an annual rate of 10 percent. Many analysts expect the decline in output and the rapid rise in prices to continue through the year. Surveys of both consumer and executive opinion indicated a pessimism perhaps unmatched since the Great Depression. Cautious spending policies could accelerate the downturn.

Despite the gloom, total activity remained well above the year-ago level, with important sectors remaining vigorous—some excessively so. Motor vehicle sales were hard hit in total, but demand continued strong for popular small cars and heavy trucks. Housing was weak, but nonresidential construction boomed. Tourism was down in many areas, but airline traffic continued to set records. Sales and output of producer goods continued to rise, especially machine tools and transportation equipment. Agriculture was prosperous with higher grain prices and good crops boosting income.

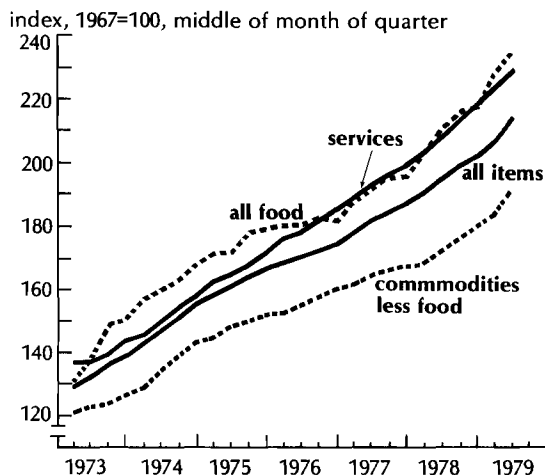
Consumer spending falters

Consumers led the expansion in 1975 and 1976. With brief letdowns or plateaus, they continued spending at high rates through 1978. Even the first quarter of 1979 showed a 13 percent rise in retail sales from the depressed first quarter of 1978. Savings rates were lower than in past years and instalment credit was used freely.

Consumer spending in current dollars was slightly lower in the second quarter than in the first quarter—an extremely rare development. Adjusted for inflation, consumer spending was down significantly. Retail sales were only 8.5 percent higher than a year earlier, while after-tax income was up over 11 percent.

The cutback in consumer purchases has been heavily concentrated in vehicles that get low gasoline mileage. Sales of motor homes mounted on truck chasses have been poor all year. Light trucks favored by consumers, es-

The rise in consumer prices has accelerated

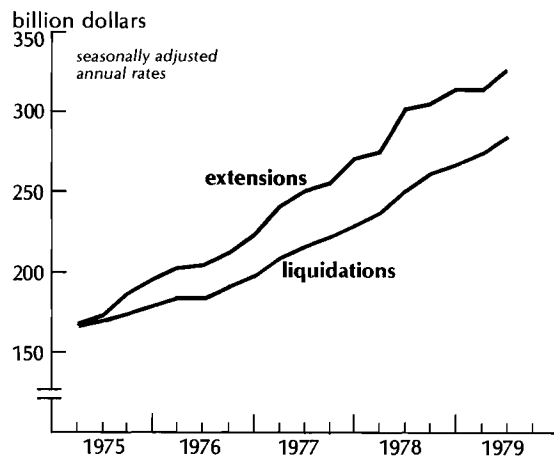


pecially four-wheel drive models, were in short supply early in the year, but sales began fading in March and in June had dropped 35 percent below a year ago. The industry had a 135-day inventory of light trucks at midyear—far more than any previous period. Sales of full-sized cars, also very strong last winter, were down over 40 percent in June, with inventories equaling 150 days' sales for some models—two to three times the preferred level. With the model changeovers coming up, manufacturers were offering historically large rebates to dealers to move surplus vehicles, especially full-size cars.

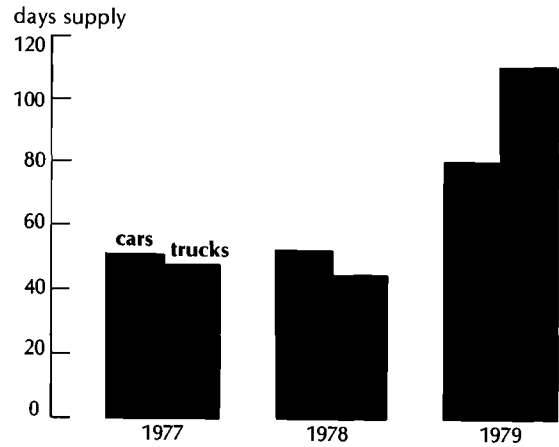
While sales of "gas guzzlers" languished, consumers paid premium prices for small cars. Some signed up on waiting lists that stretched out as much as four months. Sales of U.S.-built subcompacts were up almost 50 percent over June a year before. Sales of imported cars, almost all small, were up 9 percent in June and would have been up more if supplies had been larger.

There had been near-panic buying of small cars in early 1974, following imposition of the Arab oil embargo. Once gasoline supplies improved that spring, however, demand for small cars fell quickly, and full-size models again asserted their supremacy. This summer showed no signs of a revival of big cars similar to that of 1974.

Consumer instalment credit use soars



Car and truck inventories backed up at midyear



Customer traffic, and therefore sales, was reduced at many outlying shopping centers in May, June, and July as consumers tried to hold down gasoline consumption. Part of this loss was captured by higher catalog sales and increased sales at neighborhood stores. Another development was a pickup in home freezer sales.

The rapid rise in consumer prices (at a 13 percent rate in the first half) led by fuel and food encouraged some households to hold back on less essential spending. Increases in spendable incomes have trailed inflation significantly. Many consumers apparently increased their spending on big-ticket items late last year to beat price increases, but such anticipatory spending is usually followed by a letdown.

Another sector of consumer outlays that has suffered from the gas shortage is tourism in areas usually reached by private vehicles. With more people staying closer to home because of the high cost of fuel—and its possible unavailability—volume at less accessible resort areas was reported to be off 30 to 50 percent from year a earlier.

Capital goods retain vigor

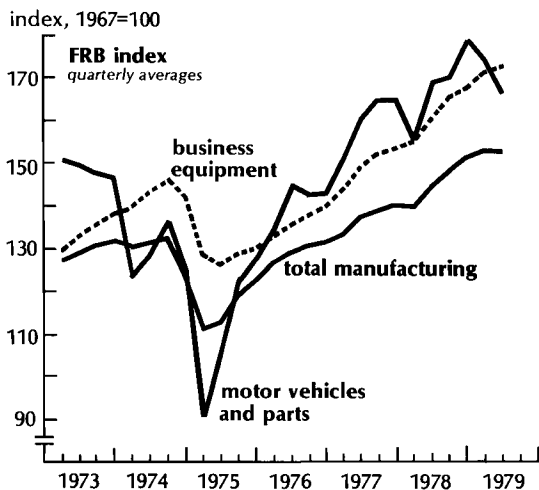
Business expects to boost expenditures on new plant and equipment 13 percent in

1979, according to the most recent government survey. That will be about the same rise as last year. Adjusted for inflation, spending will be up 5 percent, again about the same as last year. The rise in capital spending will, almost certainly, outpace the general economy, through 1979 and into 1980.

All major industry groups plan to increase capital spending substantially in 1979. The leading categories in manufacturing are machinery, paper, and chemicals. In non-manufacturing, they are transportation (air, highway, and rail), electric utilities, and telephone companies.

In contrast to the weakness in residential construction, nonresidential building will be substantially higher than last year. In the three months ended in May, outlays on new home construction were down 8 percent from a year earlier, after adjustment for inflation. Nonresidential construction was up 11 percent, with industrial construction up 33 percent and office buildings up 20 percent. New construction contracts awarded and bookings for fabricated structural steel indicate the nonresidential construction boom could extend into 1980. Recently, however, there has been a weakening in new contracts for industrial buildings, compared at least with the high level of last year.

Equipment output continues upward, as vehicles slump



New orders for nondefense capital goods leveled off in the spring, but they were still above shipments and backlogs in orders continued to build. The backlog of over \$125 billion at the end of June was a third higher than a year before. Backlogs had been rising fairly steadily since December 1976, partly because of inflation.

Order lead times are particularly long for machine tools, commercial aircraft, and some types of freight cars and locomotives. Sales of heavy trucks have been at record highs. They may exceed 200,000 units this year—a new high. Sales are also strong in equipment for construction, agriculture, materials handling, data processing, and electronic control systems.

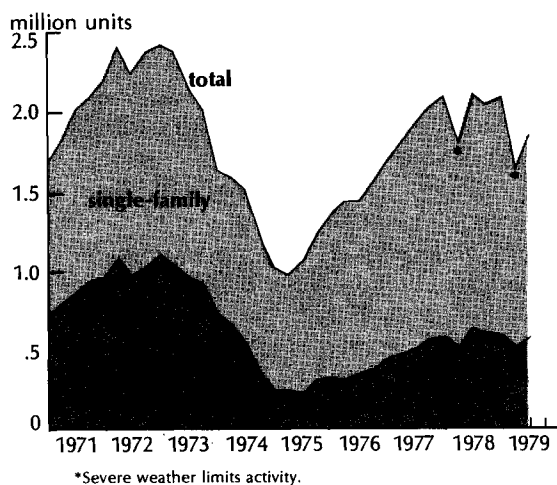
Production of business equipment, measured in real terms by the Federal Reserve's industrial production index, continued to rise through June, although total manufacturing output apparently peaked in March. In June, output of business equipment was up 7.3 percent from a year earlier. Total manufacturing output was up 4.8 percent.

If a general recession develops, some orders for equipment now on the books could be canceled without penalty. This happened in late 1974 and early 1975—and to a surprising extent. The 1974-75 experience is not likely to be equaled in degree, however. Orders are believed to have been booked more carefully this time. Also, more of the equipment on order now is badly needed to cut labor costs, improve energy efficiency, and comply with pollution controls and other regulatory mandates.

Housing starts decline

Monthly estimates of housing starts have been erratic this year, partly because of the hard winter and the catchup that followed. Most analysts expect 1979 starts in the range of 1.6 to 1.7 million units, down 15 to 20 percent from the 2 million levels of 1977 and 1978. Prospects are that starts will not improve next year. The decline in housing starts has been much greater in the Chicago area than in the

Housing starts declined sharply in the first half



nation as a whole. In the first half of the year, new permits were down 40 percent in the Chicago area from the same period a year earlier.

Nationwide, decline in housing starts has been fairly mild this cycle. After a peak of almost 2.4 million units in 1972, a three-year decline brought a drop of over 50 percent to less than 1.2 million in 1975.

Multifamily starts are holding up better in most areas than starts on single-family homes. Many of these apartments, however, will be for sale as condominiums. Of the rental units started, about three-fourths are built under government subsidized housing programs.

The decline in residential construction would have been greater but for the continued general availability of mortgage credit. In past cycles, high market interest rates caused large outflows of funds from thrift institutions and reduced the supply of mortgage funds. Also, usury ceilings in many states prevented loans at competitive rates. Since last summer, savings flows at thrifts have been aided by these institutions being allowed to offer money market certificates at competitive rates. Many states, moreover, have relaxed usury ceilings, allowing more movement in interest rates.

Despite more flexible markets, increases in interest rates to a level of about 11 percent—at least 2 points higher than last year—has priced many buyers out of the market. Rising home prices also have been important as a deterrent to home purchases. Prices of existing homes have doubled since 1972, for an annual compound rate of rise of 10 percent. Increases were even larger in the past three years.

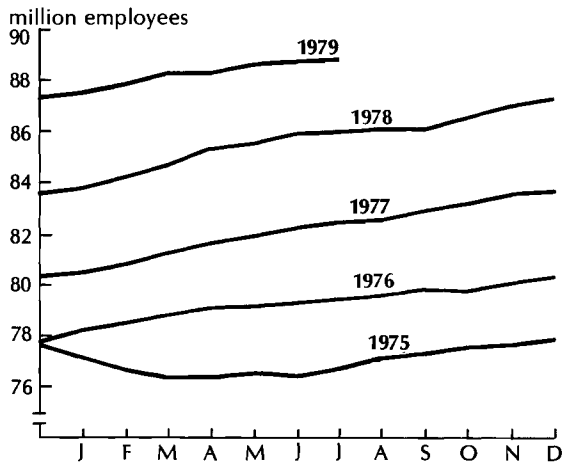
Sales of existing homes have slowed down this year, especially in the Midwest, with substantial price cuts needed to move some homes. The softer market for existing homes in outlying areas has been exacerbated by fuel stringencies. Homebuyers show signs of being more inclined to reject outlying areas in favor of older locations with ready access to public transportation, stores, and other establishments. Slower sales of existing houses hurt sales of new houses because most buyers make downpayments with the equities realized from the sale of their previous homes.

The decline in residential construction raises serious questions about the adequacy of living space in the years ahead. Households are being formed at an annual rate of about 1.5 million, and perhaps 500,000 housing units a year are demolished or abandoned as unfit. Vacancy rates for both apartments and houses are low. The spectre of a serious housing shortage could bring demands for rent controls and additional federal subsidies, despite unfortunate experience with such programs.

Employment and labor costs

One of the most impressive developments of the four-year business expansion has been the rapid rise in employment. Nonfarm wage and salary employment reached a record 88.8 million in July. That was 2.8 million more than a year earlier and 10 million more than in October 1974, the peak before the recession. From March to July, the increase in new jobs slowed to 500,000, down from 1 million in the period from December to March.

The long uptrend in payroll employment has slowed



Demand for trained (or trainable) workers has intensified in recent years, serving to push up wage rates. Strong job markets have also encouraged job hopping and absenteeism, which hamper improvements in productivity (output per worker hour).

About three-fourths of the increase in employment since 1974 has been in the trade and service industries and in state and local governments. Changes in productivity in these sectors are hard to measure, but gains are probably well below average—certainly much less than in manufacturing. In some cases, productivity has actually declined.

The combination of rapidly rising compensation and poor performance in productivity has meant a surge in unit labor costs which translates, in turn, into higher product prices. Total hourly compensation for nonfarm private jobs rose more than 9 percent last year. With practically no gain in productivity, unit labor costs rose almost 9 percent.

The change in productivity could be negative this year, particularly if a recession cuts operating rates relative to capacity. With compensation rising at least as fast as in 1978, the rise in unit labor costs could exceed 10 percent, supporting continued inflation at a similar rate.

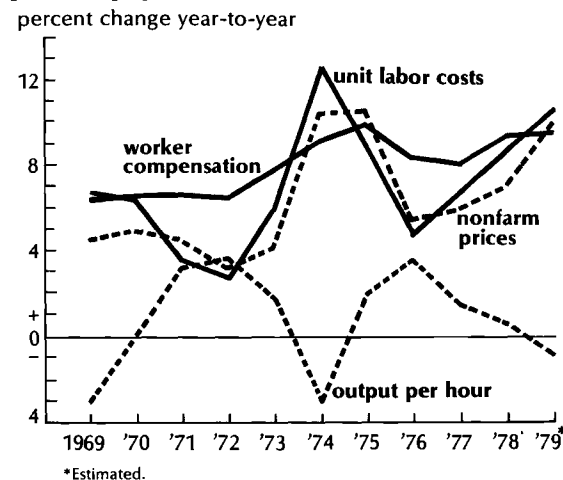
Labor pacts provide large gains

It was known before the turn of the year that 1979 would be marked by heavy bargaining in labor negotiations. Contracts covering almost 4 million workers were due to expire, compared with contracts for 2 million in 1978. Some of the most powerful labor organizations, moreover—those in the trucking, rubber, electrical equipment, auto, and farm and construction machinery industries—would participate in the bargaining.

In an effort to restrain inflation, the President announced voluntary guidelines for wage and price increases in October 1978. The wage guide, which was to cover total compensation (wages and benefits), called for maximum increases of 7 percent a year. That was compared with an 8 percent rise for all nonfarm workers in the 12 months ended in September 1978.

After an 11-day strike and lockout, the Teamsters and the trucking industry concluded a new three-year pact on April 11, providing for an 8 percent increase in the first year—assuming a 6 percent rise in consumer prices—plus substantial increases in the welfare and pension package. Although some analysts concluded that the increase in total compensation would amount to at least 9 per-

Rising labor costs push up prices



cent, for each of the three years, the Council on Wage and Price Stability interpreted the agreement as being within the guidelines.

United Airlines and the Machinists Union ratified a pact on May 24 ending a 55-day strike. The agreement was said to boost total compensation about 40 percent over three years. Goodrich and the rubber workers agreed on a three-year pact on June 15 said to be worth 40 percent, assuming a 9-percent annual rise in consumer prices. The Council on Wage and Price Stability said the airline and rubber contracts were probably not in compliance with the guidelines.

Much of the confusion over the value of new labor contracts stems, first, from the assumption of future cost-of-living adjustments (COLA), and, second, from the valuation of changes in welfare and pension benefits.

Through September—and maybe beyond if a strike is called—attention will be directed to auto workers' negotiations with the Big Three. About 700,000 auto workers are

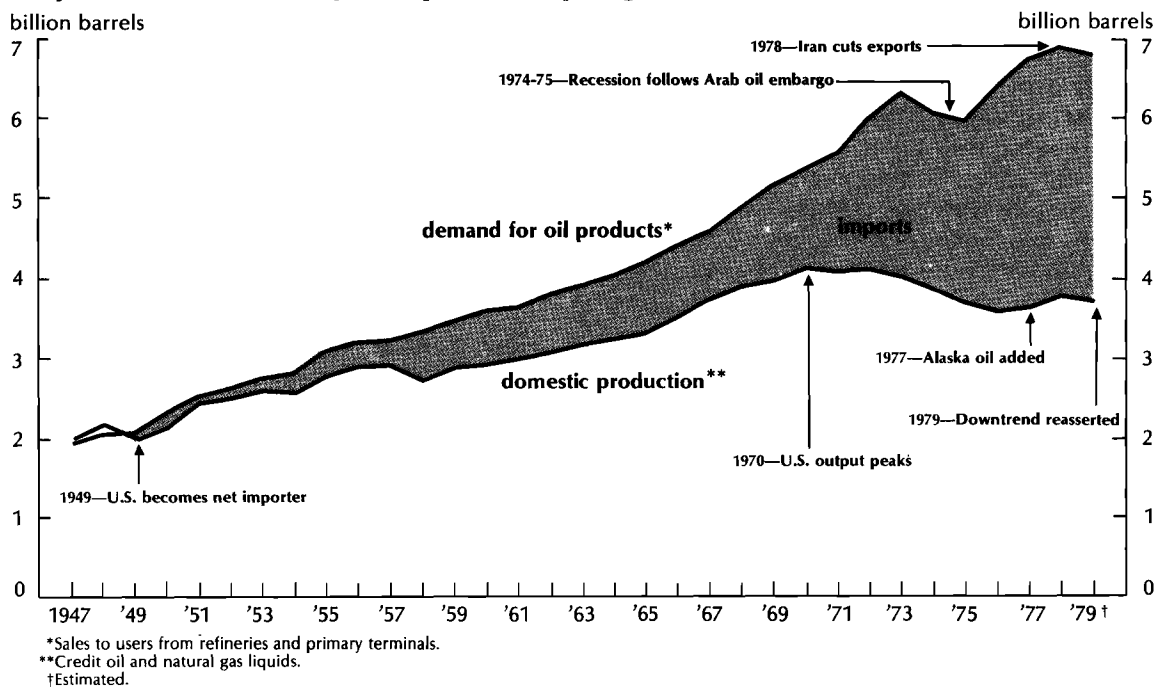
covered by contracts that expire September 14. That is more workers than were involved in all the other big labor agreements reached so far this year. The farm and construction equipment workers, whose contracts expire September 30, usually take their lead from the auto workers, as do the steel workers, who will be negotiating again next year.

Auto workers, following the example of the rubber and electrical workers, want a full cost-of-living adjustment (up from about 80 percent now), plus "substantial" increases in wages and benefits. They also want COLA for pensioners. Total compensation of auto workers, many unskilled, has increased from an average of \$5.76 an hour in 1970 to \$15.10 (about \$30,000 a year) today. That is an increase of 162 percent in nine years, or 11.3 percent compounded annually.

The oil constraint

Gasoline lines and shortages of diesel fuel have convinced most Americans that the

Dependence on foreign oil perils output growth



energy problem is real and immediate. Petroleum analysts concluded in July that a temporary increase in Saudi Arabian production of crude oil would be enough to prevent "serious" supply disruptions through the rest of the year—assuming continued conservation and barring any new interruption of deliveries from major exporting countries. As long as the United States depends on imports for almost half its oil, much of it from the troubled Middle East, a fragile balance between supply and demand is inevitable.

Another complication is the cost of imports. Soon to exceed \$60 billion annually, imports put pressure on the dollar in foreign exchange markets. On the domestic scene, sharply higher prices for gasoline, diesel fuel, and heating oil have only begun to find reflection in costs of production and distribution. No sector is isolated from this influence.

In the 20 years that preceded the Arab oil embargo in late 1973, the United States increased oil consumption 4 percent a year. During the same period, real GNP rose at a compound rate of 3.5 percent.

If oil imports are held near the current level, as the president has pledged, total U.S. supplies will decline year-by-year. Domestic production has been declining, with no signs of reversal in sight. New domestic discoveries are only about a fourth as large as current output.

If total oil supplies decline, past standards for estimating future growth will have to be discarded. With population still rising, total per capita consumption—and not just consumption of oil products—will have to decline. Those able to maintain their real income through COLA adjustments or other means will do so at the expense of those less fortunate. A shift from oil and natural gas to other fuels, including synthetics from coal or oil-shale, will take years, requiring enormous investments that, in turn, will reduce

resources available for consumption. Nuclear power is under a cloud. A substantial contribution from solar energy is not on the horizon.

What to do?

The growing apparition of recession—or feeble growth at best—coupled with unabated inflation presents policymakers with a dilemma. The problem is compounded by constraints on supplies of fuel, transportation, metals, and vital capital goods, and by limited availability of employable workers, especially professional and skilled people. A large portion of the resources released by declining sectors, vehicles and housing, is not readily transferred elsewhere.

Some people are calling for substantial tax reductions or a dramatic easing in monetary policy. But the federal government already is running a large deficit. Interest rates are near record levels, but money and credit continue to expand. Commercial bank loans and investments were 12 percent higher at midyear than a year earlier. Bank investments were up 4 percent; both total loans and business loans were up 15 percent. In addition, businesses had increased their outstanding commercial paper 40 percent. Capital markets absorbed more than \$13 billion in corporate bonds in the second quarter. That was as much as in either of the second quarters of the two previous years. Although less than last year, mortgage loans closed have exceeded the pace of earlier years.

The accepted formula of using more expansive monetary and fiscal measures to counteract lagging demand can be applied only with caution under these conditions. Given pervasive supply constraints, injection of additional purchasing power would serve more to stimulate inflation than to revive production and employment.

