Review and outlook: 1977-78

Business: upswing retains momentum

As 1978 gets under way, prospects appear favorable that the expansion that began in the spring of 1975 will continue through another year. Developments in the states of the Seventh Federal Reserve District—Illinois, Indiana, Iowa, Michigan, and Wisconsin—have paralleled national trends, allowing for differences related to their mix of industries.

In 1977, for the second straight year, large gains occurred in output, employment, personal income, and profits. Total agricultural output was at a record level. Consumers again increased spending substantially, especially on durable goods, using instalment credit extensively. Construction activity was led by residential construction, with single-family home starts at a record level. Businesses increased investments in inventories and capital goods, but at a cautious pace. Government spending on goods and services at the federal and state/local levels combined rose somewhat less than the gross national product (GNP). All classes of credit expanded substantially and interest rates rose, particularly short-term rates.

There are significant flaws in the generally favorable economic picture. Most glaring is the huge deficit in the nation's international trade balance, reflecting heavy dependence on imported oil. Incomes of most farmers are sharply depressed, paradoxically because of bountiful harvests of major crops. Many observers are concerned over the failure of business capital spending to rise more rapidly. Some bankers are disturbed that large corporations are not using credit lines more intensively. Rising market interest rates are tending to reduce the supply of funds available to thrift institutions, the dominant suppliers of residential mortgages. Some car models have not been selling well recently, and output schedules have been reduced. Finally, there is a deep uneasiness over continued price inflation at a seemingly "imbedded" rate of 6 percent annually, and an unending string of large deficits in the federal budget.

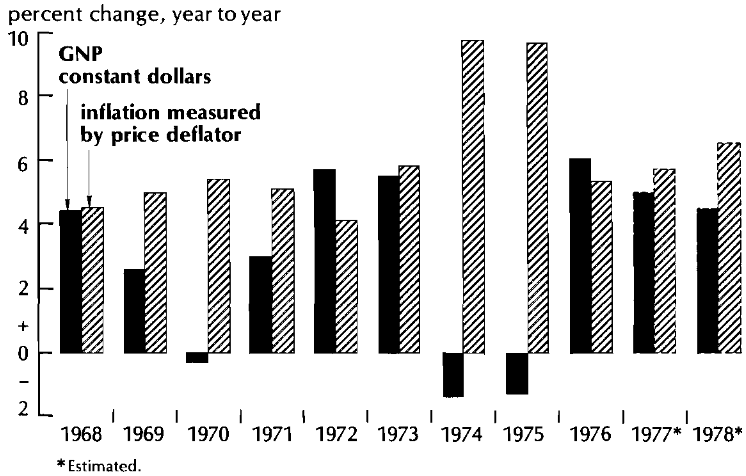
A fairly good year—but

Despite a bad start associated with severe winter weather and natural gas shortages, the performance of the economy in 1977, in broad outline, was remarkably close to the typical forecast made at the start of the year. The gross national product totaled almost $1.9 trillion, 11 percent larger than in 1976. Adjusted for inflation of 6 percent, "real" GNP was up 5 percent.

The rise in real GNP last year followed a gain of 6 percent in 1976, the first full year of expansion. Both years exceeded the long-term growth trend of about 3.5 percent, but this improvement did not fully make up the shortfall caused by year-to-year declines of more than 1 percent in both 1974 and 1975.

In mid-January of 1977 the nation was suddenly confronted with an unprecedented energy crisis. Except in the West, the winter had been abnormally cold starting in October. January was the worst month, with temperatures averaging 10 degrees or more below normal in many major cities. Requirements for natural gas to heat homes and

Output and prices are expected to increase again in 1978



households took steps, often involving expensive capital outlays, to reduce needs for fuel in general and natural gas in particular. Congress began deliberations on far-reaching legislation to encourage fuel users to conserve and, when possible, to switch to coal, and to stimulate development of new fuel supplies. A Department of Energy was established.

In the past the spectacular growth of the American economy has been based on abundant supplies of energy at relatively cheap prices. The general public is now more receptive to the warnings of experts who had been proclaiming for years that the day of cheap energy was over. Intelligent policies relating to the production and use of energy will provide the key to the nation's future growth and prosperity.

other structures seriously depleted reserves in a number of areas. Utilities were forced to sharply reduce gas deliveries to many industrial customers. Many schools were closed, and hundreds of thousands of workers were laid off temporarily. For a time it was feared that sufficient gas would not be available to heat residences in certain areas. The situation was exacerbated by high winds, heavy snows, and frozen waterways that impeded deliveries of oil and coal. The President was granted special powers to deal with the emergency.

The winter fuel crisis subsided after mid-February. Conservation measures, relaxation of some restrictions on the use and pricing of fuel, adjustments in production processes to use alternative fuels, and a favorable turn in the weather all played a part. Recovery in most sectors hit by fuel shortages and transportation problems was very rapid in late February and March. Surprisingly, data subsequently available showed economic growth in the first quarter to be at the fastest pace for any quarter of the year!

The challenges of the severe winter were met successfully and the worst consequences feared did not occur. Nevertheless, the experience left an indelible impact. The rapid rise in fuel costs, under way for years, accelerated sharply. Businesses and

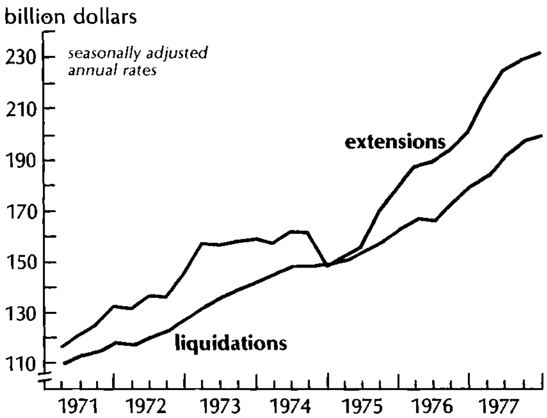
Consumers spend freely

Consumer spending on goods and services accounts for about 65 percent of GNP. Total consumer spending is closely related to disposable personal income (DPI)—current income from all sources less taxes. In the past decade consumer outlays of all types have ranged from 92 to 95 percent of DPI. The residual amount, 8 to 5 percent, is called "personal savings." This residual is influenced by the extent to which households supplement current income by incurring instalment debt.

Consumer spending remained relatively strong through the 1974-75 recession, when business firms cut back sharply on investments in inventories and capital goods. For 1975 as a whole consumer spending rose 10.2 percent in current dollars, while GNP rose 8.2 percent. In both 1976 and 1977 consumer spending increased at almost precisely the same rate as GNP.

Last year consumer spending rose more

Consumers increased instalment debt sharply last year



than 10.5 percent, while DPI rose 9.5 percent. As a result, the savings rate dropped to 5 percent, down from 5.6 percent in 1976, and well below the 7.5 percent average for the years 1973-75. In part, the drop in the savings rate last year reflected heavy purchases of autos, appliances, and other durable goods, often with the aid of instalment credit extended by banks, sales finance companies, and credit unions. Spending on durable goods rose 13 percent last year, while nondurables rose 8 percent and services, including rent, increased 12 percent.

Extensions of consumer instalment credit totaled about $225 billion in 1977, a record by a wide margin. Liquidations of these debts totaled about $195 billion. Outstandings, therefore, rose $30 billion, compared to $21 billion in 1976. Liquidations of instalment debt have been at a high rate relative to DPI on the basis of past experience. Nevertheless, most lenders report that delinquencies are at a low rate, far below the levels of the recession. The continued willingness of consumers to incur instalment debt freely will provide a major clue to the nation's economic performance in 1978.

Early in 1977 the Administration had advocated a $50 per capita tax rebate, and a similar payment to nontaxpayers, to provide consumers with additional purchasing power. As fuel bills skyrocketed in January and February, it was widely argued that an even larger income supplement was required. As the economy showed adequate improvement in the spring, however, these proposals were withdrawn.

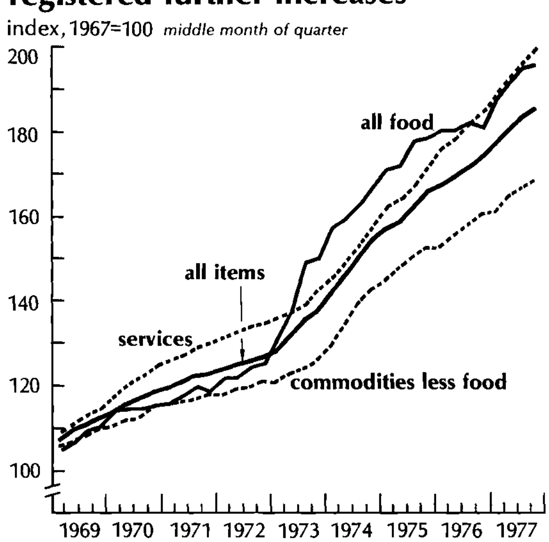
Large retailers reported sales during the Christmas season to be excellent, above budgeted expectations in many cases. Many of these companies reported a continuance of strong sales after Christmas as well. Some described their inventory positions as below desired levels, indicating a need for increasing orders to suppliers.

Consumer price rise accelerates

The government's consumer price index (CPI) averaged 181.5 in 1977 (1967=100) up 6.5 percent from 1976. In 1976 the CPI had increased 5.8 percent, down from 9 percent in 1975, and 11 percent in 1974. It had been hoped that inflation would moderate again in 1977. However, prices shot up at a 10 percent annual rate in the first quarter, partly because of weather-induced increases for fuels and foods. Prices of certain imported foods, including coffee and cocoa, soared to record highs.

The rate of inflation slowed after midyear. Nevertheless, in December the CPI

The consumer price index registered further increases



was 6.8 percent above the year-ago level. Food was up 8 percent, medical care 9 percent, and fuels and utilities 12 percent.

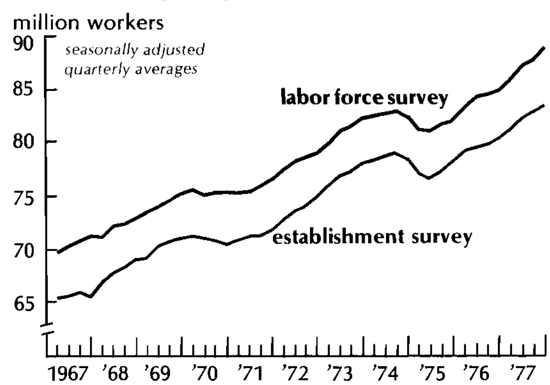
The performance of the CPI is of vital importance. For millions of individuals wages, salaries, pensions, and welfare benefits are automatically "escalated" in line with increases in this index. Thus past inflation helps to perpetuate itself. Although some of the forces that pushed up prices last year were temporary, most forecasters believe that the CPI will rise at least as fast in 1978 as in 1977.

Experience of recent years has tended to reduce the public's threshold of concern over rapid price inflation, particularly for individuals who believe they are "protected" through income adjustments. But a 6 percent rate of inflation means that the price level doubles in 12 years. At a 7 percent rate doubling occurs in 10 years; at 10 percent in seven years. For a large proportion of the population price increases of such magnitudes may cause severe hardship. Moreover, experience in many countries suggests that rapid inflation feeds on itself, thereby causing an accelerating spiral with far-reaching social and political consequences.

Employment and unemployment

In December total employment, measured by the government's survey of households, reached 92.6 million, up 4.2 million or 4.7 percent from the year-ago level.

Employment growth very rapid since the spring of 1975



Since the recession low of March 1975, employment has increased 8.4 million or 10 percent. Payroll employment, reported by employers, has traced a roughly similar pattern. Gains in employment have been fairly steady throughout the expansion, but have been concentrated in trade, service, and government rather than in manufacturing. Overall, the performance of the economy in creating jobs for a growing labor force compares favorably with earlier expansions.

Press accounts of labor market developments tend to emphasize unemployment rather than employment. The number of unemployed, defined as those without jobs who are seeking work, has remained disappointingly high despite the rapid rise in employment.

Unemployment averaged 7 percent of the total labor force in 1977, but was 6.4 percent in December. At the worst of the 1974-75 recession the rate was 9 percent. Unemployment averaged 5 percent in 1973, and less than 4 percent in the late 1960s. Unemployment has been particularly high among minorities and the young generally.

Continued high unemployment is related to the unexpectedly rapid growth of the labor force in recent years. In late 1977, 63 percent of people 16 and over were in the labor force. This was a record high, up from 62 percent a year earlier and 61 percent in 1973. The rapid rise in the labor force largely reflects an acceleration in the number of married women who have taken jobs in a job market that is increasingly receptive to them.

Labor costs and prices

In the long run inflation can be contained only if labor costs per unit of output are reasonably stable, as was the case in the early 1960s. Stability in unit labor costs, in turn, can be achieved only if increases in compensation per hour, including employer contributions for social insurance, do not exceed increases in output per hour (productivity). This has not been the case in recent years.

By Department of Labor calculations productivity grew at an annual rate of 3.3 percent in the period 1947-66. In the 1966-73 period productivity gains averaged only 2.1 percent. In 1974, partly because of the oil embargo and the recession, there was a *decline* of almost 3 percent in 1974 followed by increases of less than 2 percent in 1975 and 4 percent in 1976. Last year the rate of gain fell back to about 2 percent.

While productivity gains have slowed, increases in compensation have been maintained at a rapid pace. From an average rate of rise of almost 7 percent in the 1971-73 period, the increase in compensation jumped to 9 percent in the years 1974-77. Some contracts negotiated by unions brought increases well in excess of this average.

Largely because of the disparity between increases in compensation and increases in productivity since 1972, unit labor costs have been rising at a rate of over 6 percent, closely approximating the rate of price inflation. With compensation gains expected to approach 9 percent again in 1978, and with little hope for a substantial spurt in productivity, it is widely accepted that inflation will again approach or exceed the 6 percent level.

Manufacturing output rises

After declining more than 13 percent from September 1974 to March 1975—one of the sharpest drops since World War II—manufacturing output began a gradual recovery. In December 1976 the 1974 peak was regained. Severe weather caused a decline in January 1977, but, surprisingly, of less than 1 percent.

Manufacturing's recovery from the disruptions of January was swift. Output snapped back to the December level in February. Each month in the February-December period saw at least a slight rise in total manufacturing output, although some industries cut production at times, notably steel and autos, in response to softening demand.

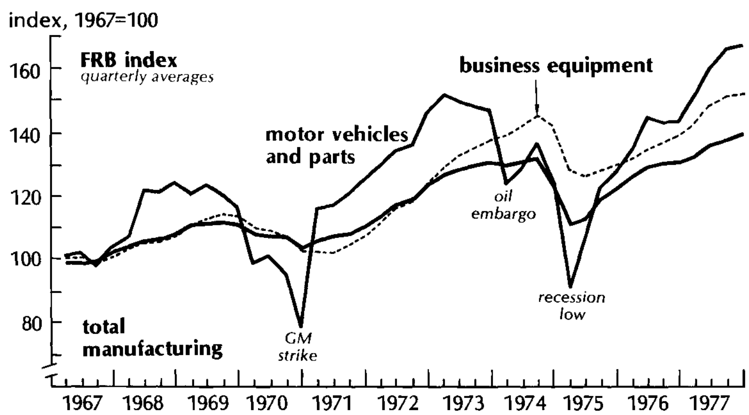
In December total manufacturing output, measured in physical units by the Federal Reserve's Index of Industrial Production, stood at 140 (1967=100). For 1977 as a whole output was up 6 percent, following a rise of 10 percent in 1976.

Durable goods manufacturing, in the aggregate, has lagged nondurables in recent years. Within these broad categories, however, there have been wide variations. Among the nondurables, chemicals have been very strong, while apparel, beset by imports, has been weak. Among the durables, the rise in business equipment and motor vehicles has exceeded total manufacturing, but activity in steel, aerospace, and ordnance has remained well below earlier peaks.

Steel plagued by imports

Shipments from U.S. steel mills rose only 2 percent in 1977 to about 91.5 million tons, instead of the 5 to 10 percent rise some analysts had anticipated at the start of the year. Last year's volume contrasted with the industry's peak years of 1973 and 1974, when shipments were at record levels of 111 and 110 million tons, respectively. Some steel-using industries bought less steel than had been expected, particularly producers of heavy capital goods, but the main reason for the

Auto industry has led expansion of total manufacturing



shortfall was rising imports.

Steel imports totaled a record 19 million tons in 1977, while exports were only 2 million tons. Since 1967, the lowest year for steel imports was the recession year 1975, with 12 million tons. Imports accounted for about 18 percent of total domestic supplies last year, approximately the same as in 1971 when users were hedging against a possible domestic steel strike. Twenty years ago imports were less than 2 percent of domestic supplies. Western European producers accounted for most of the rise in steel imports last year. A large share came into the Great Lakes region via the Seaway.

In August a number of major steel producers started a series of closings of their less efficient facilities with resulting layoffs of workers. The Administration pledged support of moves to halt "dumping" of foreign steel in U.S. markets at prices that do not cover full costs of production. A court decision also pursued the same end. In the fourth quarter there were signs that some foreign producers were easing efforts to sell in the United States. The fall in the dollar may have been partly responsible. In any case, U.S. mills reported increases in orders in December, and a rise in output was projected for the first quarter.

Motor vehicles

Cars and trucks were prime movers of the business expansion in both 1976 and 1977. Some producers are confident that last year's levels of output and sales can be equaled or even exceeded in 1978.

Passenger car sales totaled 11.2 million in 1977, up 11 percent from 1976 and second only to 11.4 million in 1973. A record total of over 2 million of the cars sold last year were imports, mainly from Japan. The share of the market going to imports at 18.5 percent also set a new high. Truck sales at about 3.5 million, including 300,000 small imports, set a record by a wide margin. Well over a half million of the trucks sold last year were vans and other light trucks purchased by households for personal and recreational use.

U.S. factories assembled 9.2 million passenger cars last year, up 8 percent from 1976, but short of the 9.7 million built in 1973. Truck output of almost 3.5 million far surpassed earlier years.

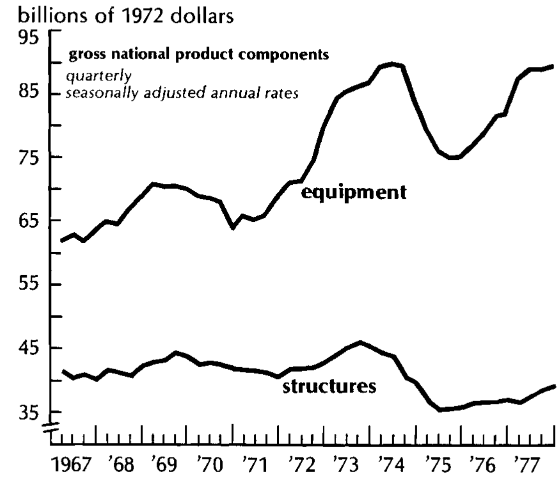
The auto industry is engaged in a massive program to provide a mix of cars that will meet government standards for improved fuel economy. In December and January some of the new intermediate-sized models were selling below expected levels, and production schedules were reduced.

Auto and truck prices have increased sharply in recent years, partly because of changes required to satisfy government rules on economy, safety, and emission control. The impact of higher prices has been softened for some purchasers by longer maturities on instalment loans with monthly payments stretching out 42 to 48 months as opposed to the 36-month maximum generally in effect until three or four years ago.

Plant and equipment

Business outlays on new plant and equipment located in the United States rose 14 percent in 1977, somewhat faster than GNP, to a total of $137 billion. After adjustment for inflation the rise was about 8 percent. Spending plans were increased slightly during the year,

Nonresidential construction has lagged spending in equipment



as indicated by the quarterly survey of the Department of Commerce.

Most industries boosted capital outlays significantly last year. Far in the lead were the motor vehicle producers, who increased spending 64 percent, mainly for new facilities to produce down-sized autos to improve gas mileage. Larger-than-average increases also were reported by the machinery, oil, and airline industries and by gas and electric utilities. Outlays by the steel and water transportation industries declined even before adjustment for inflation. Farmers also reduced spending on machinery and other facilities.

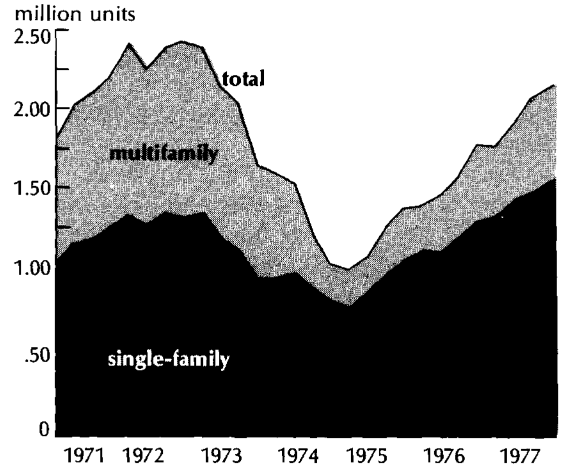
Total spending on equipment has been much more vigorous than spending on new construction. The physical volume of output of business equipment measured by the Federal Reserve's index reached 153 (1967=100) in the fourth quarter, surpassing by 5 percent the rate reached in the third quarter of 1974 at the peak of the boom. Despite a modest pickup in 1977, nonresidential private construction adjusted for inflation remained well below the level of 1974 and earlier years.

The government's preliminary survey of 1978 plant and equipment spending plans issued in January indicated an increase of only 10 percent—4.5 percent after inflation. In past expansions capital spending usually was outpacing GNP at this stage. Various economists and business executives are strongly urging reductions in corporate taxes or other measures to stimulate fixed investments.

Housing and construction

Late in 1977 construction activity was at an annual rate of $178 billion, about 18 percent above the level of a year earlier. After adjustment for 10 percent inflation, activity was up 8 percent. The residential sector again led the rise in private construction, but commercial building also was reviving. Public construction was about 3 percent below the level of a year earlier, despite an increase in outlays for water supplies and sewers.

Single-family homes lead recovery in housing starts



Construction was started on 2 million housing units in 1977, up from 1.5 million in 1976, but still well below the 1972 peak of 2.4 million. Single-family starts set a new record in 1977 of over 1.45 million, up 25 percent. The market was booming in most parts of the country. Sales of existing homes totaled 3.6 million, up 20 percent from the record set in 1976. Prices increased 10 to 12 percent on average and substantially more in some areas. Multifamily starts totaled 535,000 in 1977, up 42 percent but still 40 percent below the rate of the early 1970s.

Late in the summer home builders were hampered by shortages of materials, especially insulation and gypsum board. With needs for alterations also strong, material shortages may be a problem again in 1978. Also, many areas report a limited supply of developed lots, partly because of stricter local building regulations.

Demand for housing remains strong, but various analysts predict a decline in starts in 1978 of perhaps 10 percent. Usually, these views are predicated on the belief that rising market interest rates will significantly reduce the availability of mortgage funds.