

Sources of Economic Expansion

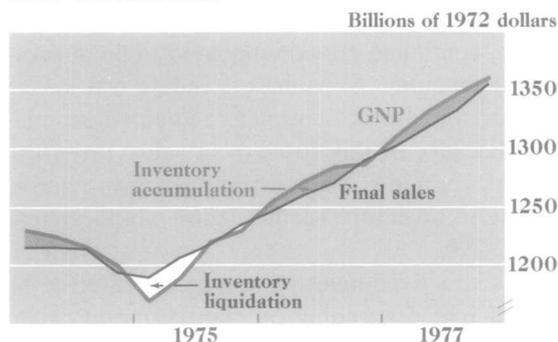
During 1977 gross national product rose by $5\frac{3}{4}$ per cent after allowance for rising prices, a larger increase than during 1976. Growth was fastest early in the year as inventory investment and consumer and business purchases of motor vehicles rebounded from the sluggish rates of late 1976. Gains in GNP slowed continuously after the first quarter. By contrast, advances in real final sales were largest late in the year.

Growth of real outlays was particularly vigorous for residential construction, business equipment, and consumer durable goods between late 1976 and late 1977. The strength of demand in these markets reflected in part a continuing recovery from the unusually depressed levels of the 1974–75 recession.

Residential building activity continued to expand briskly in 1977. Real outlays in the housing sector rose 15 per cent during the year, as total sales of homes reached a record level.

By contrast, sales of autos—a major component of consumer durable goods—jumped to a high level early in the year and then drifted lower through year-end, possibly signifying the completion of

GNP and final sales



U.S. Dept. of Commerce data, seasonally adjusted at annual rates.

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replacement buying that had been deferred during the recession and the late 1976 auto strike. As auto sales eased, however, purchases of other consumer durable goods—most notably furniture and appliances—showed renewed vigor. Consumer purchases of nondurable goods and of services each rose 4 per cent during the year.

Business fixed investment advanced 8.3 per cent in real terms during 1977, a large rise in view of the prevailing uncertainties about the effects of pending legislation and about prospects for further economic expansion in a highly inflationary environment. In addition, businesses avoided inventory imbalances for the most part by making quick adjustments in production to the uneven pace of sales during the year. A strong burst of sales at year-end, however, probably reduced stocks in some lines below desired levels.

Businesses, like consumers, increased their purchases of motor vehicles sharply early in 1977. Real purchases of other business equipment and outlays for business structures each rose about 6 per cent from late 1976 to late 1977. Industrial and commercial building activity increased markedly around midyear, but at the same time outlays for the Alaskan pipeline were reduced.

Total purchases by governments increased moderately during the year after having shown a slight decline during 1976. Much of the impetus for this rise reflected Federal fiscal initiatives, which led to a substantial increase in grants to State and local governments.

Developments in the international economy resulted in a drag on growth in domestic activity during 1977. With the economic recoveries of our major trading partners lagging behind the recovery in this country, real demands for our exports were little changed while our imports rose considerably, responding to a substantial improvement in domestic activity.

As 1977 came to a close, continued growth appeared to be in prospect for most sectors of the economy. Consumer spending was strong through the holiday season, and buyer sentiment remained at relatively high levels. In part because of this strength in sales, inventory accumulation moderated at year-end. With inventories low relative to final sales, some increase in inventory accumulation would appear to be in prospect for early 1978.

Continued growth of business fixed investment also appeared to be in prospect. Surveys of anticipated spending on plant and equipment

I. Gross national product

Seasonally adjusted, annual rates

Measure	1976 Q4	1977 Q4	1977			
			Q1	Q2	Q3	Q4
Billions of dollars						
Gross national product.....	1,755	1,962	1,811	1,870	1,916	1,962
Change in business inventories.....	— .9	13.5	13.8	21.7	23.6	13.5
Final sales.....	1,756	1,948	1,797	1,848	1,892	1,948
Percentage change from—						
	Year-earlier quarter		Previous quarter			
GNP (constant dollars).....	4.7	5.7	7.5	6.2	5.1	3.8
Final sales (constant dollars).....	4.4	4.8	3.8	5.1	4.4	6.1
Implicit price deflator.....	4.7	5.8	5.3	7.1	4.8	5.9

NOTE.—U.S. Dept. of Commerce data.

indicated that increases in such outlays in 1978 would be moderate (about 10 or 11 per cent in nominal terms) and would be somewhat less than those in 1977 (about 12½ per cent).

RESIDENTIAL INVESTMENT

Throughout the recovery housing activity has been very brisk, with especially large gains in the West and South. During 1977, record sales of new and existing homes stimulated a continuous rise in private housing starts that, together with heavy spending on additions and alterations, boosted real residential outlays 15 per cent.

The employment and product demands that were spawned by the rise in residential investment were impressive. Employment in the construction industry—including both residential and nonresidential work—increased almost 10 per cent during the year. Production of construction supplies rose 8¼ per cent, generating large gains in employment within supplier industries.

The strong showing of residential construction activity in 1977 was facilitated by developments in financial markets. Net residential mortgage debt formation is estimated to have totaled a record \$100

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billion, as lending by thrift institutions was supplemented with stepped-up participation by commercial banks and with large increases in issues of mortgage-backed, "pass-through" securities.

For the year as a whole, private housing starts totaled almost 2 million units. Starts of single-family homes rose about one-fourth from the 1976 total to about 1.45 million units, reaching the highest level since 1955. Multifamily starts totaled 535,000 units—an increase of 40 per cent from 1976, and approximately half the peak reached in 1972. About a fifth of all multifamily units were started under Federal support programs—primarily under the Department of Housing and Urban Development's Section 8 Rental Assistance Program.

Market conditions facing builders of multifamily units that were not Federally supported varied considerably across the country. In some areas low vacancy rates and rising rents provided the basis for moderate increases in rental housing, whereas elsewhere rents remained too low to justify much construction.

Demands for housing were very strong in the final quarter of the year. Sales of new and existing homes were at an annual rate of 4.8 million units, and single-family housing starts were at a very rapid annual rate—1.6 million units. Outstanding mortgage lending commitments at savings and loan associations were at a record level of almost \$35 billion, seasonally adjusted, at the end of 1977.

CONSUMPTION

Consumption spending rose unevenly in 1977, with especially large increases in the first and last quarters and comparatively small gains in the middle quarters. The surge in consumer spending early in the year reflected in large part two events: delayed purchases of new autos because of the strike in late 1976, and the unusually severe winter weather, which had widespread impacts on consumption of heating fuels and on prices of some foods. Later in the year the strong growth of employment and of disposable income, coupled with a high level of consumer confidence, provided support for an upturn in consumption spending in the final quarter of 1977.

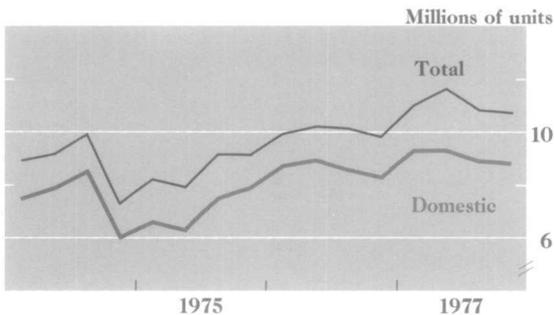
During the winter of 1976–77 consumers faced larger bills for essentials. Consumption of heating fuels rose sharply in response to unusually cold weather east of the Rockies, and spending for natural

gas, fuel oil, coal, and electricity in the first quarter of 1977 was 22 per cent above that a year earlier; about half of the rise was due to higher prices.

With the return of more favorable weather, such spending declined almost 10 per cent in the second quarter. At the same time, however, consumer outlays for food rose considerably, mainly because of large increases in prices that were partially a result of weather damage to crops. With both utility and grocery bills large, spending on most other nondurable goods was apparently held down early in the year. But during the spring, as fuel bills eased and increases in food prices began to moderate, purchases of apparel moved into an upswing that continued for the remainder of the year.

Purchases of durable goods rose at a rapid pace during the first quarter of 1977, as unit sales of automobiles jumped more than 10 per cent from the prior, strike-affected quarter. Auto sales rose further to an annual rate of 11.7 million units in the second quarter—the strongest quarterly pace since 1973. During that quarter demand for autos shifted markedly in the direction of foreign models—in part, perhaps, because the administration's energy proposals stimulated renewed interest in fuel-efficient cars. Sales of foreign-model autos continued strong and for the year totaled a record 2.1 million units. Sales of domestic autos averaged about 8.9 million units (an-

Auto sales



Data from domestic manufacturers and foreign distributors, seasonally adjusted by Federal Reserve.

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nual rate) during the second half of 1977; at that level they were below the first-half rate, below manufacturers' anticipated sales, and below production rates. As a result, inventories increased rapidly late in the year, and selected downward adjustments in production rates were instituted in November and December.

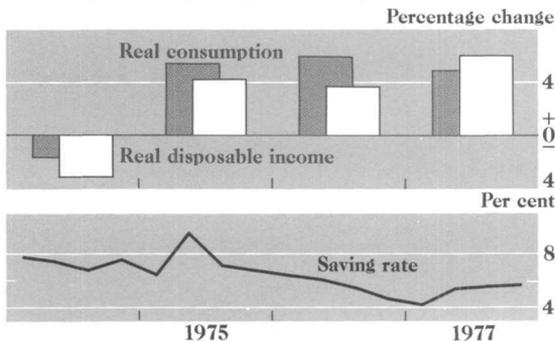
Outlays for other consumer durable goods rose strongly after mid-year. Spending for furniture and appliances, stimulated in part by record purchases of homes, rose at a 14 per cent annual rate during the last three quarters of the year. Outlays for luxury items such as jewelry and for sporting goods, as well as for a wide variety of other "nonessential" durable goods, also rose briskly late in the year.

Surveys of consumer attitudes conducted near the end of 1977 indicated that confidence remained at a relatively high level. Furthermore, substantial growth of employment and disposable income late in the year suggest good prospects for continued advances in consumer outlays during 1978.

INCOME

An acceleration in income growth supported the large increase in consumer demand in 1977. Personal income rose $11\frac{3}{4}$ per cent during the four quarters of 1977 compared with less than 10 per cent during 1976. Wage and salary disbursements in the private sector,

Income, consumption, and saving



Based on U.S. Dept. of Commerce data, seasonally adjusted at annual rates. "Real" is in terms of 1972 dollars. Changes are from Q4 to Q4.

particularly in manufacturing and services, led the advance in payroll growth; government wages and salaries were up a modest 7½ per cent.

Transfer payments rose about 7½ per cent during 1977 as reductions in unemployment insurance payments partially offset increases in other benefits. The midyear cost-of-living increase for social security recipients bolstered transfer payments in the second half of the year. Farm income, after declining steadily in response to falling farm prices, rose sharply at year-end as wheat price-support payments were distributed.

Increases in Federal estate and gift taxes held down growth in disposable income early in the year, but such income was bolstered later in the year by a cut in Federal income taxes. Lower withholding rates, which relate directly to take-home pay, were instituted in the second quarter. Consumers used some of the increase in disposable income to increase their savings. The saving rate—which had reached a 26-year low in the first quarter, in part because of 1976 estate- and gift-tax-law revisions—rose moderately during the last three quarters.

Despite the large increase in disposable income, financial obligations of the household sector reached new highs relative to disposable income late in 1977, mainly because of the record increase in home mortgage debt. The resulting rise in debt-service requirements narrowed considerably the proportion of disposable income available for current discretionary spending.

BUSINESS FIXED INVESTMENT

By the fourth quarter of 1977 real outlays for plant and equipment had risen 8.3 per cent from a year earlier. Following sharp advances in the first half, such outlays rose only moderately in the latter half of the year as sales of transportation equipment declined and construction of the Alaskan pipeline drew to a close.

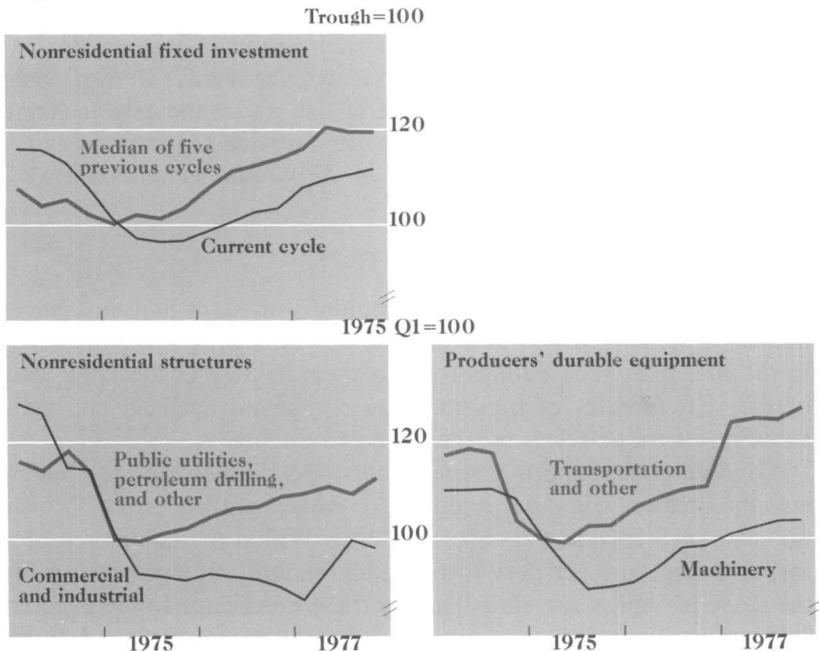
Continuing the pattern of recent years, spending on new equipment was the primary source of strength for capital outlays in 1977; over the year such spending rose 9.5 per cent. Within the equipment sector, spending on machinery rose steadily but still did not account for the share of capital spending that historical experience would suggest. Investment in structures advanced modestly during 1977—5.5 per cent, as commercial and industrial building activity strengthened in the spring, following 2 years of little change. The increase in

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outlays for fixed capital was largest in manufacturing. Spending by producers of durable goods was particularly robust, whereas that by materials producers was damped by relatively low levels of capacity utilization and by readily available foreign supplies at competitive prices.

Despite healthy gains in the equipment sector during 1977, the total of real spending for business fixed investment in the fourth quarter was still 3 per cent below its earlier peak; a more typical cyclical experience would have seen such outlays almost 13 per cent above their previous peak. This shortfall can be attributed in part to substantial unused capacity. At the year-end capacity utilization rates in manufacturing were around 83 per cent, not much above those in late 1976 and well below the levels normally experienced after 33 months of cyclical recovery and expansion. Low-to-moderate

Capital outlays



Based on U.S. Dept. of Commerce data in 1972 dollars, seasonally adjusted. National Bureau of Economic Research reference-cycle trough, 1975 Q1 = 100.

utilization rates in most industries have probably had a depressing effect on growth of fixed capital throughout the recent expansion.

Other factors also contributed to the relatively modest recovery in investment spending. Continued uncertainty over tax and energy policies heightened the caution that already characterized longer-range investment plans. The weakness in stock prices pushed up the cost of equity capital and made the acquisition of existing productive capacity relatively attractive. However, financial developments outside of equity markets did not seem to affect capital spending in an adverse manner.

INVENTORY ACCUMULATION

Investment in business inventories proceeded cautiously in 1977, and inventory-sales ratios remained below historical averages in most sectors. After the abrupt shift to liquidation that had taken place in the final quarter of 1976, inventory accumulation picked up sharply in the first quarter of 1977. And in the second and third quarters there were further advances, in response to gains in final demand. At year-end, however, the pace of accumulation abated considerably, as final sales strengthened. Indeed, at the year-end stocks may have been a bit on the lean side relative to sales in some sectors; hence, there could be some pick-up in accumulation during early 1978.

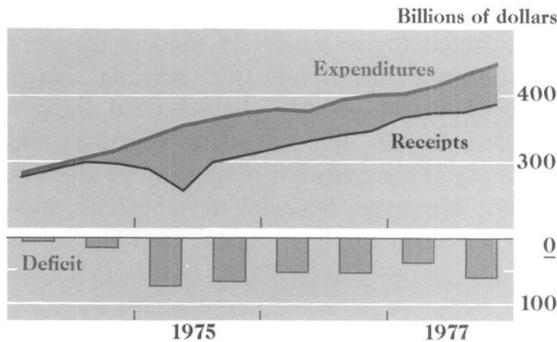
GOVERNMENT

The Federal Government continued to run a substantial deficit in 1977, reflecting in part new fiscal initiatives. In particular, spending was buoyed by grants-in-aid to States and localities to implement various countercyclical spending programs, and receipts were held down by tax cuts embodied in the Tax Reduction and Simplification Act of 1977. The Federal budget deficit, on a national-income-accounts (NIA) basis, was about \$50 billion during calendar year 1977—\$4.5 billion less than in 1976.

Real Federal purchases rose slightly more than 7 per cent during 1977. This contrasts with the small decline during 1976. Nondefense spending was bolstered by large purchases of agricultural products by the Commodity Credit Corporation following a sharp drop in farm prices at midyear. Although the Federal civilian work force remained essentially unchanged in 1977, Federal payrolls rose 7 per cent.

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Federal receipts and expenditures



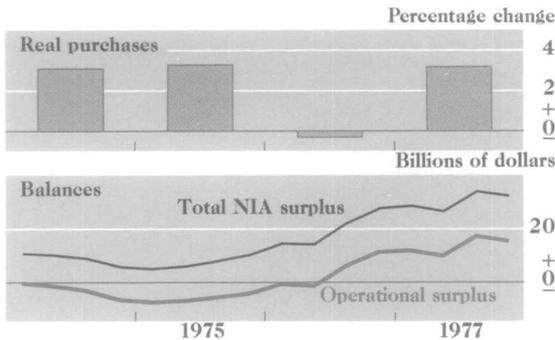
Based on U.S. Dept. of Commerce data (national income series) seasonally adjusted at annual rates.

Federal receipts rose 12½ per cent for 1977 as a whole—considerably less than in 1976. Personal tax collections increased almost 16 per cent, led by a large increase in receipts of estate and gift taxes associated with legislated changes in the method of taxing gifts. Social insurance tax collections rose about 12½ per cent, reflecting an increase in the social security taxable wage base as well as increases in payrolls.

State and local government purchases of goods and services advanced 3¼ per cent from late 1976 to late 1977, after a slight decline during 1976. Increases in Federally subsidized public service jobs accounted for a large part of the rise. Between the fourth quarter of 1976 and the fourth quarter of 1977, over-all employment in this sector increased by 337,000 jobs. This compares with an advance of 225,000 positions the previous year. Despite an infusion of counter-cyclical Federal aid for public works projects and a record volume of bond issues in 1977, real capital spending by State and local governments rose only marginally and at year-end was about one-fifth below the level 3 years earlier.

State and local government receipts rose about 11¼ per cent for 1977 as a whole. The advance reflected increases in local tax bases associated with the general economic expansion as well as sharply higher Federal grants-in-aid during the second half. Total spending was held below revenues throughout the year as many governmental

State and local government spending



Based on U.S. Dept. of Commerce data, seasonally adjusted; changes are from Q4 to Q4. Operational surplus excludes net savings by social insurance funds.

units used some of their receipts to rebuild cash balances that had been drawn down by several years of fiscal stress. As a result of such fiscal conservatism and some unspent countercyclical grants, the operational balance—which excludes net savings by social insurance funds—showed a record annual surplus of almost \$14 billion.

NET EXPORTS

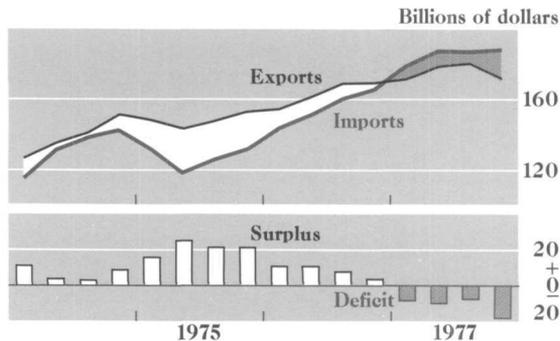
U.S. net exports of goods and services showed a deficit of \$11 billion in 1977 on an NIA basis—a sharp reversal from the \$7.8 billion surplus recorded in 1976. The swing into deficit was the result of a very large increase in the merchandise trade deficit that was only partially offset by a small rise in net investment income.

Exports of merchandise from the United States were little changed in real terms as the slow economic recovery of our major trading partners constrained expansion of demand. Slow growth of capital investment in both developing and developed countries limited increases in demand, particularly for machinery and industrial materials, which normally constitute about half of our merchandise exports. The volume of agricultural exports in 1977 continued the strong trend established in 1976, but the value of these exports declined in the latter half of the year as grain prices fell sharply.

The sharp rise in merchandise imports in 1977 reflected a broad range of developments, but the dominant factor was the substantial

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U.S. foreign transactions



U.S. Dept. of Commerce data, seasonally adjusted at annual rates. Includes both goods and services.

rise in petroleum imports. The total bill for imported oil rose about 30 per cent from its 1976 total to \$45 billion, as increased consumption and substantial expansion of petroleum inventories were met almost entirely by imports. Price increases accounted for about one-third of the rise. Imports of industrial supplies, autos and related equipment, and consumer goods increased significantly, reflecting mainly demands generated by the expansion of the domestic economy. At the same time, sharply higher prices for coffee and some other imported agricultural commodities provided a significant boost to the cost of imports during the early part of the year.

Net exports of services and military transactions (NIA defined) rose \$5 billion in 1977 to \$22 billion. These transactions have become a large part of total exports over the past several years, as income from U.S. investment abroad and sales of military equipment to foreign governments have grown.