The Economy in 1986

The economy completed a fourth consecutive year of expansion in 1986, with real gross national product increasing about 2 percent. The rise in overall activity resulted in 2½ million new payroll jobs. The jobless rate for civilians continued to edge down and was 6¾ percent at year-end.

Inflation slowed sharply in 1986: virtually all broad measures of price trends showed their smallest increases in many years. Although the sharpness of the deceleration owed much to specific developments in the markets for oil and other commodities, the favorable inflation performance also represented at a fundamental level the continuation of trends in wage and price behavior fostered by policies in place since the early part of the decade.

While output continued to grow in 1986, the economy still was characterized by pronounced imbalances. These were reflected in marked disparities in economic performance across industries and geographic areas. In particular, domestic oil exploration and investment were cut back severely, and only massive federal subsidies sustained many farm enterprises faced with sharply lower crop prices. In addition, major segments of the industrial sector continued to struggle with intense foreign competition, and relatively low rates of capacity utilization, along with a glut of office space, depressed capital spending.

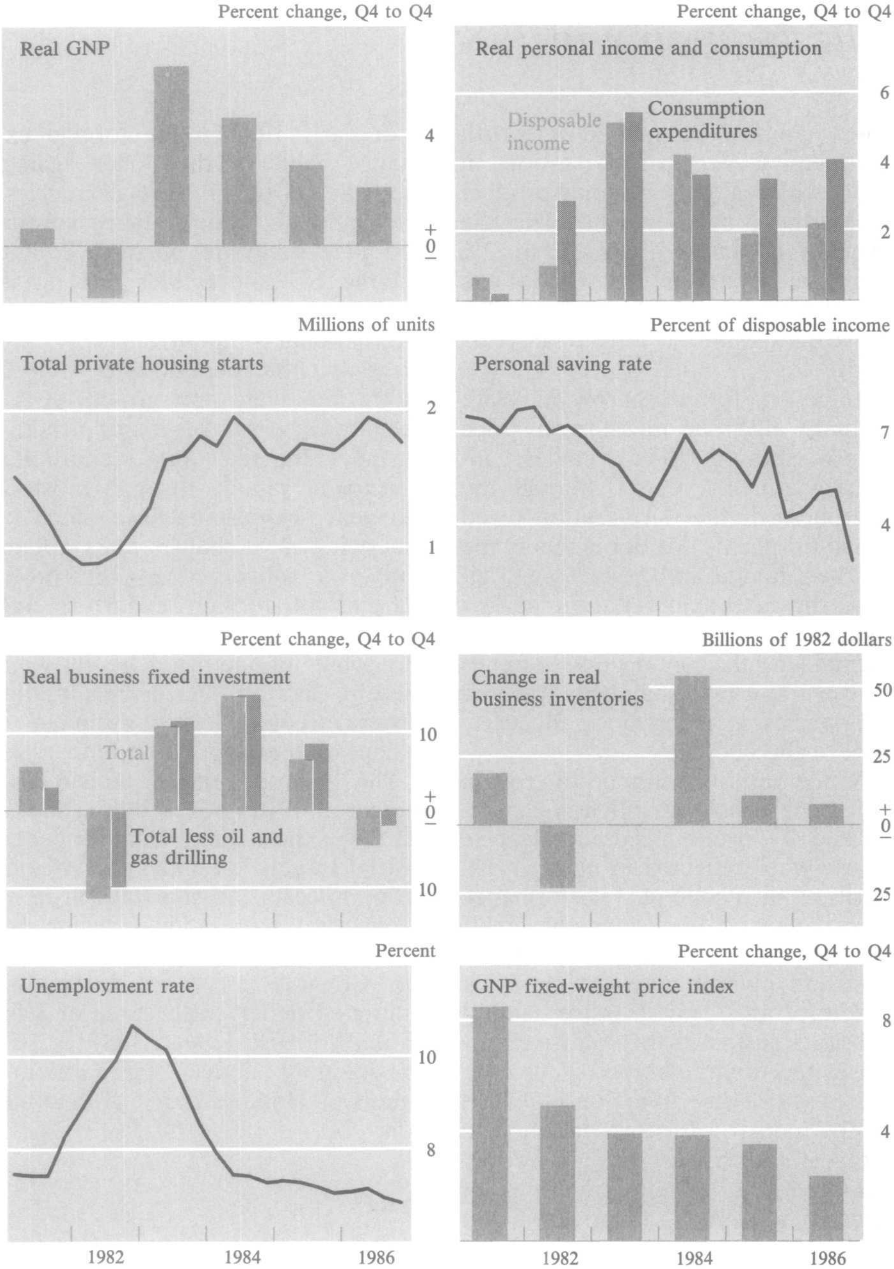
The most serious imbalances continued to be in the external sector and in the federal budget. Despite the decline of roughly 40 percent after early 1985 in the foreign exchange value of the dollar against the other Group of Ten currencies, the country's trade balance continued to deteriorate. Growth in the volume of exports did pick up in 1986 in response to the enhanced international competitiveness of U.S. firms, but the rebound was damped by the relatively slow growth of the economies of U.S. major trading partners. Import volumes continued to expand rapidly through most of the year, in part because much of the swing in exchange rates apparently was absorbed in the profit margins of foreign exporters and U.S. distributors, and increases in the prices of imported goods were thereby limited. As a result, the current account deficit continued to widen, to about $150 billion in 1986.

The federal budget deficit also increased, hitting $221 billion in fiscal 1986; the deficit vastly exceeded official targets, as underestimates of program costs and shortfalls in revenues offset the deficit-reducing actions taken by the administration and the Congress. The much smaller estimated deficit in the area of $175 billion for fiscal year 1987 is still considerably above the Gramm–Rudman–Hollings target of $144 billion.

Prices

The GNP fixed-weight price index increased about 2½ percent in 1986. This was the smallest yearly increase in more than two decades and followed a rise of 3½ percent in 1985. Some other popular measures of

Indicators of Economic Performance

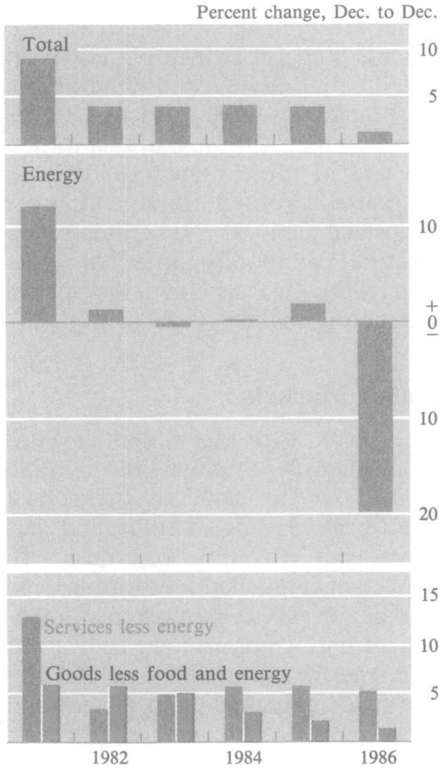


All data are seasonally adjusted, and those that involve dollar amounts are in 1982 dollars. The unemployment data are from the U.S. Department of Labor; the other data are from the U.S. Department of Commerce.

prices decelerated even more. The consumer price index for goods and services rose only about 1 percent, and the producer price index for finished goods actually fell 2½ percent.

The greater deceleration in the consumer and producer price indexes than in the GNP price measure reflects the greater importance of energy prices in those indexes. The movements in energy prices over the past year or so have been striking. World crude oil prices dropped from $26 per barrel in late 1985 to about $11 per barrel around midyear; they trended up over the second half of 1986 and rose to around $18 per barrel in early 1987 in the wake of the agreement on production limits reached by the Organization of Petroleum Exporting Countries in late December. The drop in crude oil prices in the first half of 1986 was reflected promptly in prices of gasoline and home heating oil, which fell around 30 percent over the course of the year. Charges for electricity and natural gas also declined, but much less than those for refined petroleum products. On balance, retail energy prices declined 20 percent over the year.

Consumer Prices



The data are from the U.S. Department of Labor.

Price increases outside the energy area generally remained moderate in 1986. Retail food prices rose 4 percent, a bit more than in 1985, reflecting the effects of the summer's heat wave in the Southeast. However, prices of retail goods excluding food and energy continued to slow and, on balance, were up only 1½ percent. The influence of the depreciating dollar on consumer goods prices was highly variable across sectors and relatively small overall. Sizable increases occurred in dockside prices for foreign cars and for some types of home electronic and photographic equipment, and retail prices of such goods accelerated. But there was little evidence of any significant aggregate impact on other consumer goods. Prices for nonenergy services also slowed somewhat, but they still rose around 5 percent, boosted by continued large increases for medical services and higher premiums for various types of insurance.

Prices for many basic industrial commodities continued to decline over most of the first three quarters of 1986. Excess capacity in some basic industries and the generally abundant world supplies of many primary commodities contributed significantly to the weakness in these prices. Sluggish industrial activity in the United States and other large economies also was a factor. Prices in a number of these markets turned up late in the summer, possibly in response to the firming in U.S. industrial activity. Nonetheless, industrial commodity prices at year-end were well below the peaks reached in mid-1984.

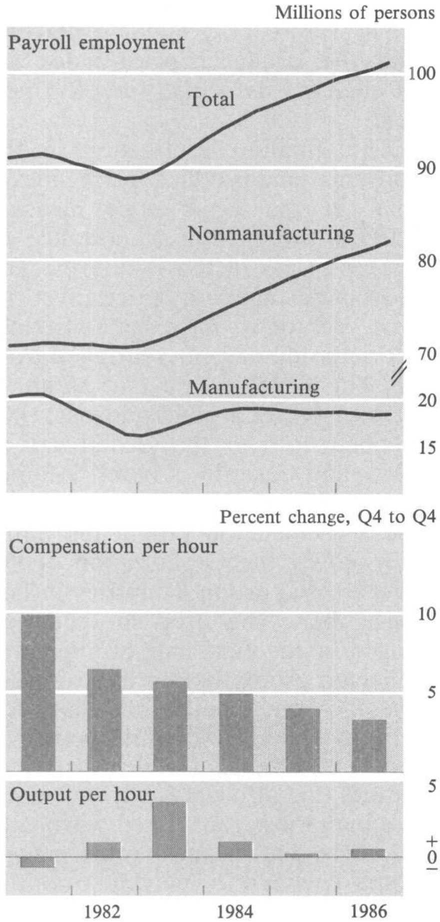
Labor Markets

The increase of 2½ million in nonfarm payroll employment in 1986 was about the same as the robust 1985 pace. Hiring in trade and services again was quite vigorous, with especially large increases for business and health services. In contrast, manufacturing employment contracted over the first three quarters of 1986. However, it picked up in the autumn in response to an apparent firming in industrial activity; in nondurable goods industries, where output had risen steadily, employment gains were widespread, but hiring at firms producing durable goods remained spotty.

The growth in the number of jobs in 1986 slightly exceeded the rise in the labor force. As a result, the civilian unemployment rate edged down, to 6¾ percent at year-end. Labor force participation maintained its upward trend: women continued to enter the workforce in large numbers, in part responding to expanding job opportunities; and participation rates for adult men held steady. Overall, the number of persons employed relative to the working-age civilian population reached 61 percent, a new high.

Wages continued on a path of moderation in 1986. Hourly compensation in the nonfarm private sector,

Labor Market Conditions



Payroll employment covers the total nonfarm sector; hourly compensation and output cover the nonfarm business sector. All data are from the U.S. Department of Labor.

as measured by the employment cost index, rose about 3¼ percent, ¾ percentage point less than in 1985. The deceleration in wages reflected the continued slack in labor markets as well as the reduction in price inflation, and was widespread across industries and occupations. In the unionized sector, wage increases were especially small, and a number of alternative, more flexible compensation arrangements were adopted, including the substitution of lump-sum payments for general wage increases. The advance in compensation for white-collar workers also moderated, although it remained more rapid than that for other groups.

Unit labor costs in the nonfarm business sector were well contained in 1986, because of the relatively moderate increase in wages. Gains in output per hour, however, have averaged less than 1 percent per year since 1984; through 1986 the underlying trend in productivity for the business sector as a whole improved only slightly from the very low pace of the 1970s, and it remains well below the pace of earlier years in the postwar period. In contrast, productivity in manufacturing has increased about 3½ percent a year over the past three years, in part because intense foreign competition has induced many producers to modernize their factories and streamline their operations.

Household Sector

The household sector was the major contributor to overall growth again in 1986. Consumer spending increased a robust 4 percent in real terms, even though income growth was only moderate on average for the second year in a row. Real disposable income soared in the first half of the year because of the plunge in energy prices, but it dropped after midyear as wage and salary gains remained sluggish and farm and interest income declined. Consequently, the personal saving rate fell to around 4 percent, the lowest annual average in nearly 40 years.

The growth in consumption last year was paced by strong gains in purchases of durable goods, while spending on nondurable goods and services increased at about the same rate as in the preceding few years. Among durable goods, sales of new cars rose to around 11½ million units. Effective prices of new cars were held down by incentive programs of below-market financing for domestic makes and by the introduction of low-priced imports from Korea and Yugoslavia. At the same time, sales of Japanese and European models remained brisk, despite sizable increases in their sticker prices. Total outlays for other durable goods also rose substantially, as consumers greatly increased their purchases of home electronics products, and sales of furniture and appliances were supported in part by the robust pace of home sales in recent years.

Housing activity continued to expand in 1986. Total housing starts edged up to 1.8 million units for the year as a whole, their highest level since the late 1970s. Single-family homebuilding increased about 10 percent, bolstered not only by a sizable decline in mortgage rates—which brought rates on fixed-rate loans back to single digits for the first time since 1978—but also by continuing favorable demographic trends. In contrast, multifamily activity dropped off considerably over the course of the year; an important factor in the decline was the restraining influence of record-high vacancy rates on rental units, especially in key markets in the South. In addition, several provisions of 1986 tax legislation have reduced the profitability of building rental housing.

Business Sector

Business spending on plant and equipment declined 4½ percent in real terms in 1986. Much of the drop was attributable to the sharp cutback in oil and gas well drilling, which fell almost 50 percent over the year. But investment outside of the energy sector also was generally lackluster as many firms, especially in the tradable goods sector, trimmed expansion plans in light of relatively low rates of capacity utilization and continuing uncertainty about future sales trends. Investment in computers and other office machines remained on the path of reduced growth evident since the fading of the high-tech spending boom in 1985, in part because of concerns about the productivity-enhancing potential of some of these products. More generally, the widely anticipated elimination of the investment tax credit prompted many firms to accelerate spending in late 1985; despite another tax-related speedup late last year, the net effect of tax changes in 1986 appears to have been to depress equipment spending. Outlays for nonresidential structures outside of the energy area, which had risen exceptionally fast over the first few years of the expansion, fell in 1986. The decline in office construction, where vacancy rates reached extraordinarily high levels, was especially sharp.

Inventory investment generally remained subdued in 1986. Faced with sluggish orders and stable or falling prices, manufacturers continued to trim their stocks. In the retail and wholesale trade sector, inventories of goods other than automobiles increased moderately for the second year in a row; however, at year-end such stocks appeared to be roughly in line with near-term sales prospects. At auto dealers, stocks fluctuated widely but showed little net change over the course of the year; drops in inventories coincided mainly with the special incentive programs that pushed sales to record levels, and also with a burst in sales in December in anticipation of tax changes in 1987.

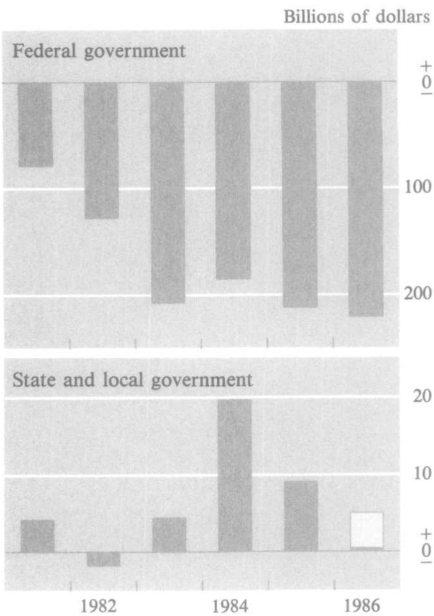
After-tax economic profits in the nonfinancial corporate sector, although at fairly high levels relative to GNP, were essentially unchanged overall from 1985. There was considerable diversity in the performance of individual industries: the petroleum industry experienced a marked decline in profits associated with the fall in oil prices, while petroleum-using industries such as chemicals and plastics fared relatively well.

Government Sector

Even though the administration and the Congress have taken significant action in the past few years to reduce it, the federal budget deficit has remained huge. In fiscal year 1986 the imbalance hit a record $221 billion, exceeding the previous year's deficit by more than $8 billion. Revenue growth in 1986 was restrained by the relatively moderate rise in nominal income, while demands on some programs were strong, especially in the areas of agriculture and health. Although the budgetary program put in place for fiscal year 1987 was nominally consistent with the Gramm–Rudman–Hollings deficit target of $144 billion by January 1987, the published estimates of the administration and the Congressional Budget Office were around $175 billion, equal to about 4 percent of GNP—still a high ratio historically.

Excluding changes in farm inventories held by the Commodity Credit

Government Surpluses and Deficits



The data on the federal government deficit are for fiscal years and are on a budget basis; they are from the U.S. Department of the Treasury.

The data on state and local governments are for operating budgets. They are on a national income accounts basis, and they come from the U.S. Department of Commerce.

The total 1986 surplus of $5.0 billion for state and local governments contained about $4.7 billion of nonrecurring inflows from settlements involving oil company overcharges, Outer Continental Shelf rents, and stripper-well charges, as well as shifting of some revenue-sharing payments to fiscal 1986.

Corporation (CCC), federal purchases of goods and services rose appreciably in 1986. Over the course of the year defense purchases in real terms grew about 7 percent, similar to the increases recorded since the early 1980s. Excluding CCC purchases, real nondefense outlays, which have shown little net change in recent years, were essentially flat.

Purchases of goods and services by state and local governments rose briskly in 1986, mainly because of a surge in construction activity. An upswing in the school-age population in recent years has led to a step-up in school building, and numerous programs are under way to expand and improve the infrastructure. The growth in overall outlays has been sustained despite concerns about the financial condition of the sector. Excluding some special one-time inflows, such as previously escrowed oil-lease payments, the combined surplus of operating and capital accounts for the sector as a whole fell to near zero in 1986. Many states, including most of those in the energy and agricultural regions, responded to budgetary pressures by raising taxes and cutting spending.