The Economy in 1989

Real gross national product grew 2½ percent over the four quarters of 1989; the rise was 2 percent if adjustment is made for the recovery in farm output from the drought losses of 1988. By either measure, growth was significantly slower than in 1987 and 1988; in those two years, however, the pace of expansion had been unsustainably rapid and had pushed activity to a point at which inflationary strains were beginning to emerge. As growth slowed over the course of 1989, the pressures on resource utilization eased somewhat, particularly in the industrial sector. Nonetheless, the overall unemployment rate remained at 5.3 percent, the lowest reading since 1973; and inflation, as measured by the consumer price index, remained at 4½ percent despite the restraining influence of a dollar that was strong for much of the year.

The deceleration in business activity in 1989 reflected, to some degree, a tightening of monetary conditions; this tightening, which had begun in early 1988 and extended into early 1989, was undertaken with a view toward damping the inflation forces. Partly as a consequence of the tightening, the U.S. dollar appreciated in the foreign exchange markets from early 1988 through mid-1989 and contributed to a slackening of the growth of foreign demand for U.S. products. At the same time, domestic demand also slowed, more for goods than for services.

Producers of goods, facing slower growth of demand in both the domestic and foreign markets, shifted to a lower rate of growth in activity than that of the two previous years. The rise in industrial production was a bit more than 1 percent in 1989; it had been 6½ percent in 1987 and 4½ percent in 1988. Employment in manufacturing, after increasing a total of 90,000 over the first three months of 1989, declined 190,000 over the remainder of the year.

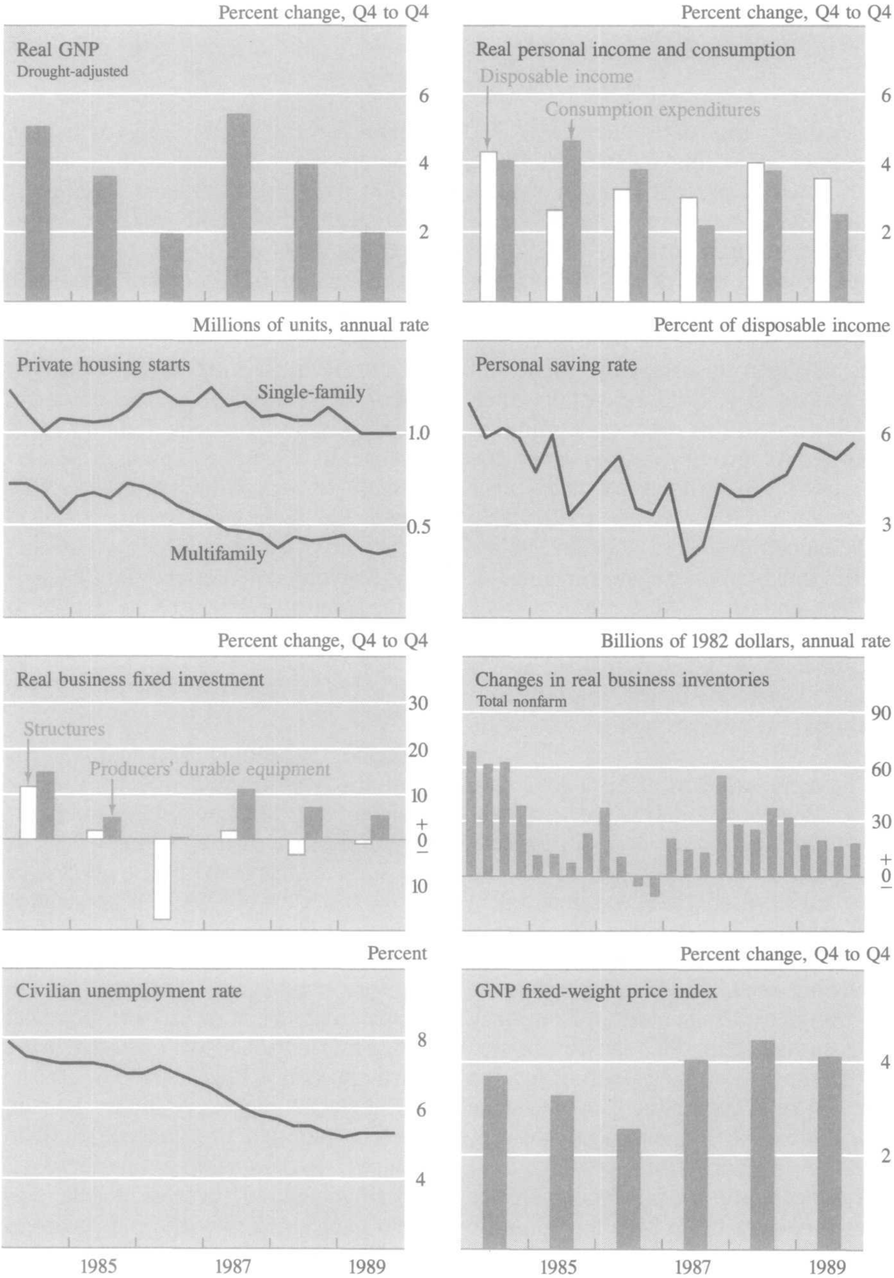
The rate of inflation was about the same in 1989 as it had been in the preceding two years. While the appreciation of the U.S. dollar through the first half of the year helped to hold down the prices of imported goods, the high level of resource utilization continued to exert pressure on wages and prices. In that regard, the moderation in the expansion of real activity during 1989 was a necessary development in establishing an economic environment more conducive to progress over time toward price stability.

The Household Sector

Household spending softened significantly in 1989 as the demand for motor vehicles and housing weakened markedly. Real consumer spending on goods and services increased 2½ percent over the four quarters of 1989, 1¼ percentage points less than in 1988. Growth in real disposable income also slowed last year but, for a second year, outstripped growth in spending; as a result, the personal saving rate increased to 5½ percent in the fourth quarter of 1989.

The slackening in consumer demand was concentrated in goods rather than services. Real spending on durables, which had jumped 8 percent in 1988, was about unchanged over the four quarters of 1989; the sharp slowing mainly reflected a slump in purchases of motor vehicles. Spending on nondurable goods also decelerated, increasing only 1 percent in 1989 after a 2 percent advance in

Indicators of Economic Performance



The data are seasonally adjusted. The unemployment data are from the Department of Labor; the rest are from the Department of Commerce.

1988. By contrast, real consumer spending for services continued to rise rapidly. Among the service categories, outlays for medical care increased 7¼ percent in real terms last year; the sustained rapid growth in these outlays in recent years has raised their share of total consumption expenditures to 11 percent – a larger share than is spent on any major category except food and shelter. Outlays for other services rose 3½ percent in 1989, with sizable increases in a number of categories.

Sluggishness of autombile sales was evident when 1989 began, and it persisted through much of the year. In total, the sales of cars and light trucks fell more than ¾ million units in 1989, to 14½ million. The weakness of sales was most pronounced during the fourth quarter. Third-quarter clearance sales on 1989-model cars had led buyers to advance the timing of their purchases but apparently did not raise overall demand appreciably. Sales thus fell back in the fourth quarter. This decline was exacerbated by a relatively large increase in sticker prices on 1990-model cars; although part of the price increase reflected the inclusion of additional equipment – notably the addition of passive restraint systems to many models – consumers nevertheless reacted adversely. Beyond these influences, longer-run factors appear to have damped the demand for autos and light trucks during 1989; in particular, the robust pace of sales earlier in the expansion seems to have satisfied demand that had been pent up during the recessionary period of the early 1980s. The rebuilding of the motor vehicle stock suggests that future sales may be aligned more closely with pure replacement needs than was the case through much of the 1980s.

Real spending on residential construction fell 7 percent over the four quarters of 1989. Construction was pressured throughout 1989 by the overbuilding that occurred in some locales earlier in the decade. Vacancy rates remained especially high for multifamily rental and condominium units, and the starts of multifamily units fell for the fourth year in a row. In addition, high prices for houses appeared to be restraining demand in some regions in which price increases had been especially large over the course of several years.

Mortgage interest rates declined more than a percentage point, on net, between the spring of 1989 and the end of the year, helping to arrest the contraction in housing activity; however, the response to the easing in rates appears to have been muted somewhat by a reduction in the availability of construction credit, likely reflecting, in part, the tightening of regulatory standards in the thrift industry and the closing of a number of insolvent institutions. Exceptionally cold weather also hampered building late in the year.

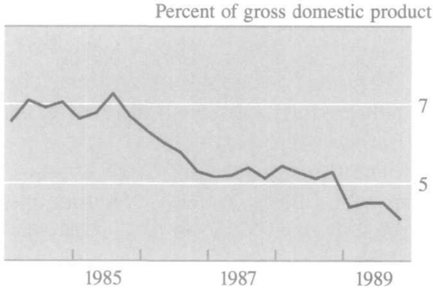
The Business Sector

Business fixed investment, adjusted for inflation, changed little on net during the second half of 1989 after surging at an annual rate of 7¾ percent during the first half. Although competitive pressures forced many firms to continue seeking efficiency gains through capital investment, the deceleration in overall economic growth made the need for capacity expansion less urgent, and shrinking profits reduced the availability of internal finance.

Spending on equipment moved up briskly during the first half of 1989; gains in outlays were particularly notable for information processing equipment – computers, photocopiers, telecommunications devices, and the like. However, in the second half of the year equipment outlays leveled off; growth in the information processing category slowed sharply, and spending in most other categories was either flat or down. Business purchases of motor vehicles, in particular, dropped sharply in the fourth quarter. Spending on aircraft, which had been very strong over the first three quarters of 1989, also was down in the final quarter as the strike at Boeing curbed production and shipments. In an exception to the pattern of second-half softness, outlays for agricultural machinery moved up smartly through year-end, buoyed by the substantial improvement in the financial health of the farm sector over the past few years. Overall, business spending on equipment increased 5¼ percent in real terms over the four quarters of 1989—about 2 percentage points below the pace of 1988.

Business spending for new construction, which had dropped 3½ percent in real terms in 1988, edged down further in 1989. Commercial construction, which includes office buildings, remained especially weak; vacancy rates for office space persisted at high levels in many areas, lowering prospective returns on new investment. Outlays for drilling and mining, which had dropped 20 percent over the four quarters of 1988, moved down further in the first quarter of 1989; later in the year, drilling activity revived in response to a higher level of crude oil prices. The industrial sector was the most notable exception to the overall pattern of weakness in heavy construction: Real outlays for new industrial facilities increased 10 percent in 1989, largely because of construction that had been planned in 1987 and 1988, when capacity in many basic industries tightened substantially and profitability was improving sharply.

Corporate Profits after Taxes



Profits of nonfinancial corporations from domestic operations, with adjustments for inventory valuation and capital consumption.

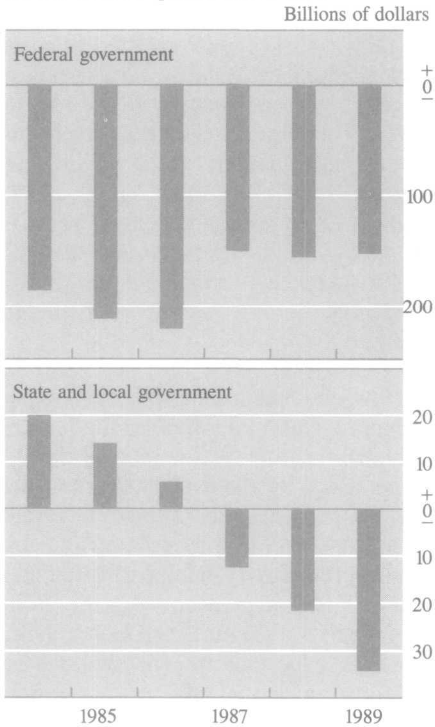
The slowdown in investment spending during the second half of 1989 likely was exacerbated by the deterioration in corporate cash flow. Before-tax operating profits of nonfinancial corporations dropped 17½ percent from the fourth quarter of 1988 to the fourth quarter of 1989; measured as a share of the value of gross domestic output, the pre-tax profits of nonfinancial corporations averaged 7¾ percent in 1989, the lowest reading since 1982. Fundamentally, this squeeze on profits arose from increased pressures from labor and materials costs at a time when domestic and international markets had become highly competitive and aggregate demand was being restrained.

Inventory investment in the nonfarm business sector totaled $18 billion in real terms in 1989, a slower pace of accumulation than in 1988. Some of the buildup in stocks took place in industries where orders and shipments were generally strong—aircraft, for example. Inventories in some other sectors became uncomfortably heavy at times and precipitated adjustments in orders and production. The clearest area of inventory imbalance at the end of 1989 was at auto dealers, where stocks of domestically produced automobiles were at 1.7 million units in December—almost three months' supply at the sluggish sales pace of the fourth quarter. In response, the domestic automakers implemented a new round of sales incentives and cut sharply the planned assembly rate for the first quarter of 1990. Elsewhere in the retail sector, inventories moved up substantially relative to sales at general merchandise outlets. Overall, though, most sectors of the economy adjusted fairly promptly to the deceleration in sales in 1989 and appeared to have avoided being caught with large holdings of unwanted stocks.

The Government Sector

Federal purchases of goods and services—the part of federal spending that is counted in GNP—fell 3 percent in real terms over the four quarters of 1989. Reductions in the stock of farm products owned or financed by the Commodity Credit Corporation—negative purchases,

Government Surpluses and Deficits



The data on the federal government are for fiscal years. They are on a unified budget basis and come from the Department of the Treasury.

The data on state and local governments are for operating and capital accounts. They are on a national income accounts basis and come from the Department of Commerce.

in effect—accounted for about one-third of the decline. Lower defense purchases made up most of the remainder. Nondefense purchases excluding those of the CCC were down slightly in real terms from the fourth quarter of 1988 to the fourth quarter of 1989; increases in such areas as the space program and drug interdiction were more than offset by general budgetary restraint that imposed real declines on most other discretionary programs.

In terms of the unified budget, the federal deficit in fiscal year 1989 was $152 billion, slightly smaller than in 1988. Growth in total federal outlays, which includes transfer payments and interest costs as well as purchases of goods and services, picked up a bit in fiscal year 1989. Outlays were boosted at the end of the fiscal year by the initial $9 billion of spending by the Resolution Trust Corporation. On the revenue side, growth in federal receipts increased in fiscal 1989. Income tax payments by individuals jumped, and corporate and social security tax payments also rose strongly.

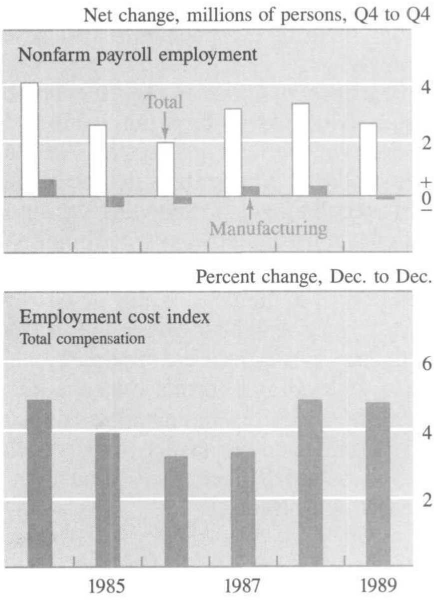
Purchases of goods and services at the state and local level rose 3 percent in real terms over the four quarters of 1989, a rise similar to the increases in each of the two preceding years. Spending for educational buildings increased, and employment in the state and local sector rose 350,000 over the year, a change driven partly by a rise in hiring by schools. The budgetary position of the state and local sector deteriorated further over the four quarters of 1989, as the annualized deficit of operating and capital accounts, which excludes social insurance funds, increased $18 billion.

Labor Markets

Employment growth slowed in the second half of 1989; nonetheless, nonfarm payrolls increased nearly 2½ million during the year. The bulk of this expansion was in the service-producing sector. By contrast, the manufacturing sector lost 100,000 jobs. These cutbacks were more than accounted for by declines in the durable goods industries, which were affected by the slump in auto sales, the second-half sluggishness in capital spending, and the effects of a stronger dollar on exports and imports.

Despite the slowdown in the creation of new jobs, the overall balance of supply and demand in the labor market changed little over the year and, on the whole, gave a sense of continued tightness. The civilian unemployment rate, which had dropped sharply in 1987 and 1988, closed out 1989 at 5.3 percent—unchanged from the level of a year earlier. Other indicators gave a similar picture: The number of "discouraged" workers—those who say they would re-enter the labor force if they thought they could find a job—declined in 1989, as did the number of workers who accepted part-time employment when they would have preferred full-time. The proportion of the civilian population with jobs reached an historic high.

Labor Market Conditions



The data are from the Department of Labor. The employment cost index is for private industry, excluding farm and household workers.

The tightness of labor markets and the persistence—according to surveys—of inflation expectations in the 4 to 5 percent range kept pressure on labor costs. The employment cost index for wages and salaries in nonfarm private industry increased 4¼ percent over the twelve months of 1989, about the same as the rise during 1988. Benefit costs in 1989 continued to rise more rapidly than wages and salaries, with health insurance costs remaining a major factor; nonetheless, the rate of growth in overall benefit costs slowed, in part because of a smaller increase in social security taxes than in 1988. Total compensation, which includes both benefits and wages and salaries, rose 4¾ percent during 1989. Growth of compensation in the service producing sector—at 5 percent—continued to outpace the gain in the goods-producing sector by about ¾ percentage point.

Productivity gains were lackluster in 1989, a phenomenon typical of a slowing economy. Output per hour in the private nonfarm business sector increased only ½ percent over the four quarters of the year—1 percentage point below the rate of increase in 1988. In the manufacturing sector, productivity gains during the first half of 1989 kept pace with the 1988 average of 3 percent; in the second half, however, productivity growth slowed a little, to an annual rate of 2 percent. Reflecting both the sharp increase in hourly compensation and the slowing in productivity, unit labor costs in private nonfarm industry rose 4¾ percent over the four quarters of 1989—the largest increase since 1982.

Price Developments

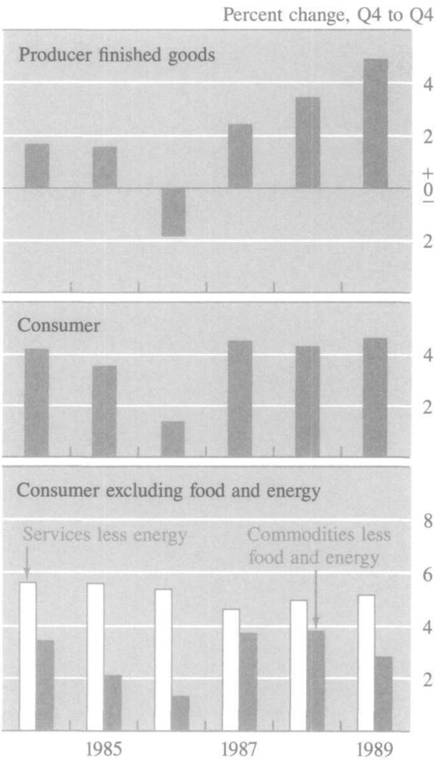
Inflation in consumer prices remained in the neighborhood of 4½ percent for the third year in a row. Although some relief came in the form of stable import prices, the continued pressures on domestic resources, particularly in the labor markets, precluded any easing of overall price increases. During the first half of the year, inflation was boosted temporarily by a sharp runup in energy prices and a carry-over from 1988 of drought-related increases in food prices. However, inflation in food prices slowed during the summer, and a drop in energy prices in the second half retraced about a third of the earlier run-up. The effect of import prices in holding down inflation also was more apparent in the second half of the year than in the first half.

Food prices increased 5½ percent at the retail level over the year, slightly more than in 1988, when a number of crops were severely damaged by drought. A poor wheat crop in 1989 and a shortfall in dairy production were among the factors that prevented food prices from decelerating. In addition, increases in demand, including sharp increases in exports of some foods, also appear to have played a role, as did continued increases in the costs of food processing and marketing. In December, a hard freeze hurt fruit and vegetable crops in Florida and Texas and sent prices soaring as a new year began.

Consumer energy prices surged 16 percent at an annual rate during the first six months of 1989, but fell at a 5 percent rate in the second half. During the first half, increases in the cost of crude oil drove up retail energy prices. In addition, the introduction of tighter standards governing the composition of gasoline during summer months boosted summer gasoline prices. Later on in the year, gasoline prices eased considerably, reflecting the passthrough of lower prices for crude oil and the expiration of the summertime standards. Taking the twelve months of 1989 as a whole, the increase in retail energy prices came to a bit more than 5 percent. At year-end, heating oil prices were surging in response to increased demands and supply disruptions caused by December's unusually cold weather. Crude oil prices at the end of 1989 had moved up to around their highest levels since the big price collapse of 1986.

The rise in the consumer price index for items other than food and energy was almost 4½ percent in 1989, about the same as in 1988. Developments in this

Prices



Consumer prices are for all urban consumers. The data are from the Department of Labor.

category likely would have been less favorable had the dollar not been appreciating in foreign exchange markets through the first half of 1989. The prices of consumer commodities excluding food and energy decelerated sharply, and this slowdown was particularly marked for some categories where import penetration is high, including apparel and recreational equipment. In contrast to goods prices, the prices of nonenergy services – which make up half of the overall consumer price index – increased 5¼ percent in 1989, slightly more than in 1988. The pickup in this category was led by rents, medical services, and entertainment services.

At the producer level, prices of finished goods increased 7½ percent at an annual rate during the first half of 1989 – almost twice the pace of 1988 – but slowed to an annual rate of 2½ percent in the second half. Sectoral developments that affected the prices of finished goods at the producer level were similar to those that affected consumer prices. At earlier stages of processing, the index for intermediate materials excluding food and energy, a broad indicator of trends in materials prices, decelerated sharply during the first half of the year, and then edged down in the second half. Over the four quarters of 1989, this index registered a net increase of only 1 percent, compared with a rise of more than 7 percent in 1988; the deceleration appears to have reflected a relaxation of earlier pressures on capacity in the primary processing industries, along with the influence of the rise in dollar exchange rates through the first half of 1989. These same factors also caused the prices of industrial commodities to weaken as the year progressed; price declines were especially sharp for some primary metals, such as copper, aluminum, and steel scrap. At year-end, however, prices of industrial commodities appeared to be stabilizing. ■