The Economy in 1985

The economy completed a third consecutive year of expansion in 1985, with the real gross national product rising about 2 percent over the year. This rise was sufficient to create 3 million new payroll jobs, and the unemployment rate edged down.

An important achievement of the current recovery has been the sustained expansion of economic activity without any relinquishing of the progress achieved toward the goal of price stability. Most broad measures of price increase indicate that inflation slowed to about a 3½ to 3¾ percent rate in 1985, somewhat less than the pace registered over the previous two years. The containment of inflation has been aided by the high exchange value of the dollar and excess world supplies of many basic materials, which have left prices unchanged or lower for a wide range of imported goods, industrial commodities, agricultural products, and petroleum. More fundamentally, wage increases in the aggregate have been restrained, limiting upward pressure on costs.

Although output and employment continued to grow in 1985, the rate of expansion was slower than some had anticipated and thus raised concerns about the sustainability of the recovery. Furthermore, the pattern of developments in the past year had some disturbing aspects: domestic and foreign demands continued to be diverted away from goods and services produced in the United States, draining income from U.S. households and businesses and exacerbating an inventory correction by U.S. firms as their sales lagged; meanwhile, consumers continued to increase their spending at a substantial clip, but they did so only by borrowing at a pace that pushed household debt burdens to still higher levels.

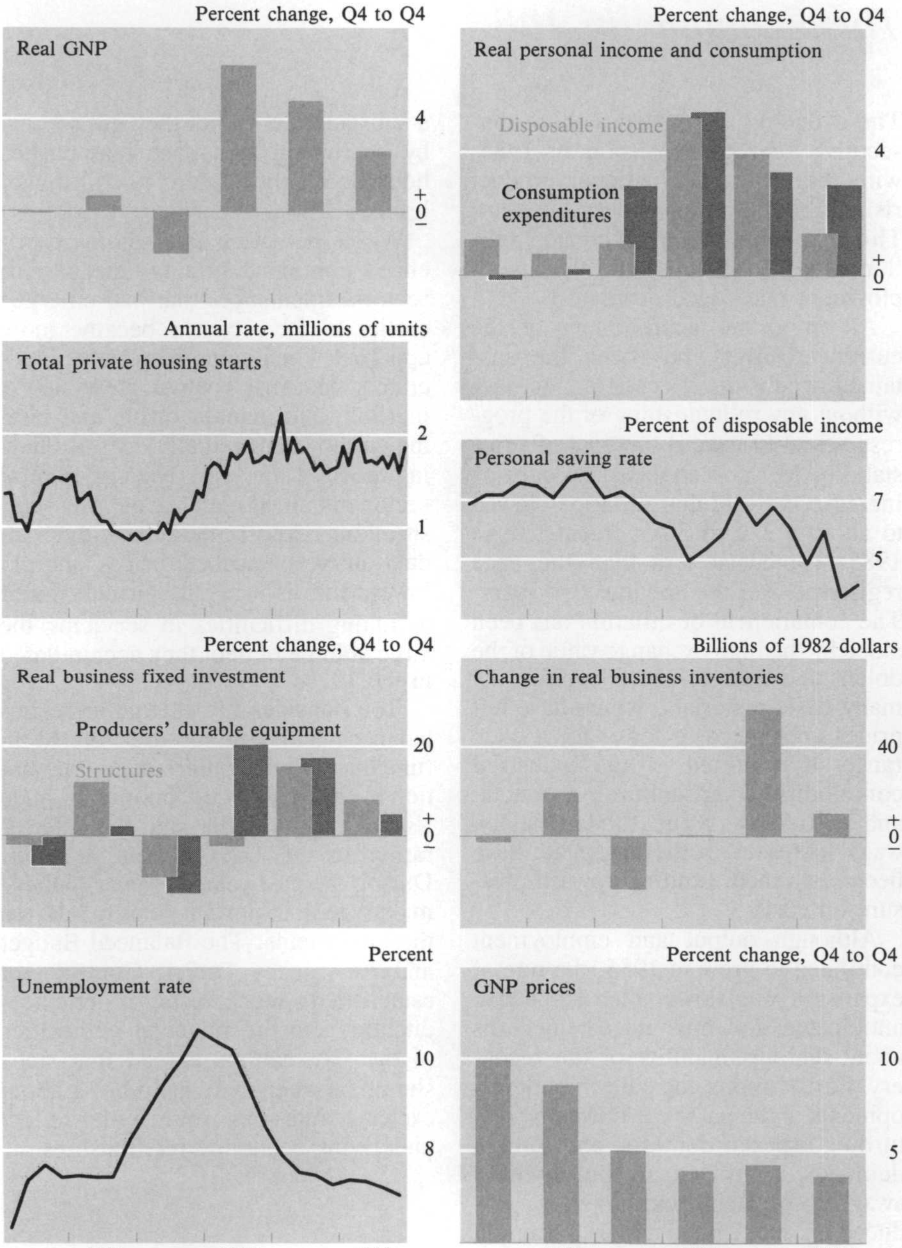
While the nation as a whole experienced continued growth, the serious sectoral imbalances that had emerged earlier in the recovery became more apparent when gains in activity moderated. Industrial output grew slowly in 1985, and manufacturing and mining employment actually declined during much of the year. The agricultural sector remained under acute pressure; shrinking export markets and abundant harvests pushed prices sharply lower, and as a result, farmers faced mounting difficulties in servicing the large volume of debt they accumulated in the 1970s.

To a considerable extent, these imbalances and stresses are related to fundamental disequilibria in the nation's finances: the continuing huge federal budget deficit and the deterioration in the U.S. current account. During the past year, however, policymakers took important steps to address these problems. The Balanced Budget and Emergency Deficit Control Act established a mechanism for deficit reduction, and the financial authorities of the G-5 nations agreed that steps should be taken that would bring about exchange rates that would better reflect underlying economic relationships.

Prices

The consumer price index advanced 3¾ percent over 1985, compared with the 4 percent increase of the previous year. The GNP fixed-weight price in-

Indicators of Economic Performance



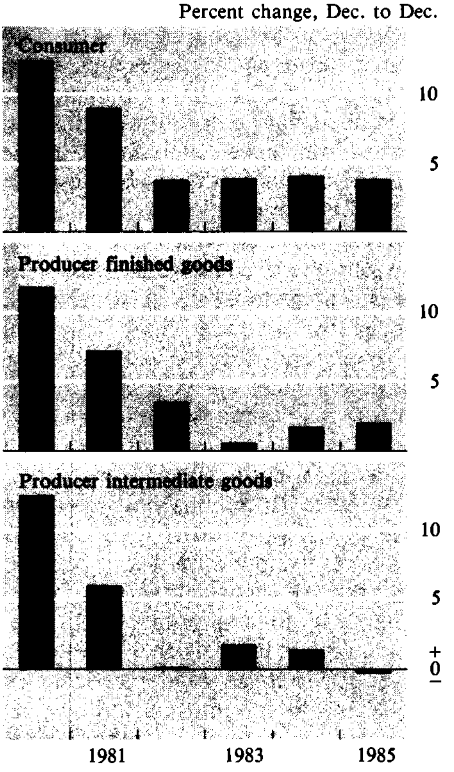
All data are seasonally adjusted, and those that involve dollar amounts are in 1982 dollars. The unemployment data are from the U.S. Department of Labor; the other data are from the U.S. Department of Commerce.

dex, which includes production for businesses, government, and export, as well as for consumers, increased 3½ percent, about ½ percentage point less than the average increase over the preceding two years. Producer prices of finished goods advanced 1¾ percent last year, and prices of intermediate materials were essentially flat.

Progress toward price stability has been sustained by several factors, the most important of which have been subdued inflation expectations, moderate increases in wages, and the influence of the high value of the dollar on the prices of imports and goods that compete with imports. In addition, developments in the food and energy markets continued to restrain overall inflation in 1985. Energy prices showed little change last year; however, a substantial margin of unutilized productive capacity, continued conservation efforts, and the debt-servicing problems of several important oil producers all contributed to a surplus of oil and a sharp break in oil prices on world markets at the end of the year. Crop prices at the farm remained depressed by diminished export demand and high levels of production. Lower prices for crude foods and small increases in processing costs held the increase in retail food prices to 2¾ percent last year.

Prices for many basic industrial commodities fell during 1985. Weak expansion of industrial production in the United States and in other major industrial countries limited the growth in demand for raw and semiprocessed materials. Furthermore, the high prices for many raw commodities that prevailed in the 1970s and early 1980s induced a rapid expansion of capacity, particularly in developing countries. With productive capacity in place and with many of these countries facing massive debt-servicing requirements, supplies of commodities on world markets have remained plentiful.

Prices



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

On balance, price increases outside of the food and energy area held steady in 1985. Consumer prices other than those for food and energy increased about 4½ percent, a bit less than in 1984. The prices of retail goods excluding food and energy were held to a gain of 2 percent last year, at least in part because of small increases or declines in markets where import competition is substantial. Price increases for nonenergy services remained at about a 5¾ percent annual rate last year. Capital equipment prices rose 2¾ percent, somewhat more than in 1984.

Household Sector

Spending in the household sector remained strong in 1985, despite a sharp slowing in the growth of income. As wage and salary gains slowed, interest income weakened, and farm income plummeted, real disposable income rose only about 1¼ percent, much less than the 4 percent increase of the previous year. Meanwhile, real personal consumption expenditures, buoyed by continued high levels of borrowing, advanced 3 percent—only a little less than in 1984. As a result, the personal saving rate fell to an average of about 4½ percent in 1985, well below historical norms.

The strength in household spending in 1985 reflected further gains in outlays for consumer durables, especially purchases of new automobiles. Sales of new cars totaled more than 11 million units, the strongest selling pace since 1978. Sales of domestic autos picked up to 8¼ million units in response to the general downtrend in interest rates, several rounds of price and financing concessions offered by manufacturers, and increased availability of some models that had been in short supply in 1984. Sales of foreign cars climbed to a record level of more than 2¾ million units for the year; a greater volume of exports to the United States was permitted under the Japanese voluntary restraint program for 1985-86, and this accounted for most of the pickup.

Activity in the housing sector was flat in 1985. The number of new homes started during the year remained at about the 1¾ million unit level of the preceding two years. Construction of single-family housing showed no new strength despite favorable demographic trends and a decline in mortgage rates to their lowest level in six years. A tightening of qualification standards by lenders and mortgage insurers and higher mortgage insurance premiums may have offset some of the effect of lower mortgage rates. Construction of multifamily housing remained at the relatively high level of the two previous years, notwithstanding high and rising vacancy rates for rental units. Rental housing construction was supported by heavy issuance of debt by state and local authorities, partly in anticipation of constraints that would be imposed on such debt by proposed tax reform legislation.

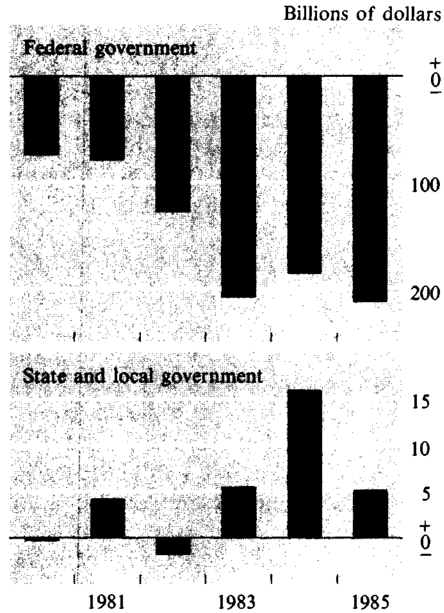
Business Sector

Economic conditions in the business sector were mixed in 1985. After-tax economic profits of nonfinancial corporations as a group increased sharply for a third consecutive year, to the highest percent of GNP since the late 1960s. Many firms in manufacturing and mining industries, however, encountered significant difficulties brought about by the high value of the dollar. In addition to the influence of the exchange rate, pressure on prices and profits in the agricultural and energy sectors was exacerbated by ample supplies in world markets.

Business spending for equipment and structures rose 6¼ percent in real terms in 1985, supported by falling interest rates, declining relative prices for capital equipment, and continued efforts to modernize facilities in order to meet intensified competition. Nevertheless, the growth in business fixed investment was well below the extraordinary pace of the preceding two years. Furthermore, the slowdown in capital outlays was widespread and occurred in many categories of high-technology equipment, heavy industrial machinery, and structures. Some deceleration of investment spending can be expected as an expansion progresses and the growth of sales subsides to more sustainable rates. However, declining capacity utilization further slowed the pace of investment in 1985 in the industrial sector, and rising vacancy rates for office buildings contributed to slower growth in expenditures for nonresidential structures.

Businesses accumulated inventories at a much reduced pace in 1985, particularly in the manufacturing sector. In real terms, nonfarm business inventories rose $10½ billion, after the large investment of $56 billion in 1984. In the manufacturing sector, sluggish orders and stable or falling prices induced a cautious approach to inventory accumulation; factory inventories declined over the second half of 1985 and were little changed on balance for the year as a whole. Stocks in the trade sector increased over the year, boosted by a large rise in auto inventories in the fourth quarter. Excluding autos, inventories at retail establishments increased about in line with the moderate rise in sales.

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.

Government Sector

The federal budget deficit rose to $212 billion in fiscal year 1985. Although the economic expansion continued to boost receipts, outlays rose even faster, with large increases in agricultural support payments, interest payments, and defense purchases. The deficit remained at a historically high 5 percent of GNP, absorbing a large share of the net saving available to the domestic economy.

Purchases of goods and services by the federal government, which add directly to GNP and constitute one-third of total federal expenditures, posted another strong advance in 1985. Excluding changes in farm inventories held by the Commodity Credit Corporation (CCC), federal purchases were up 3¼ percent over the year, after adjustment for inflation. Defense outlays, which increased 6 percent over the year, continued to provide a major boost to federal purchases. CCC purchases rose sharply as low market prices encouraged farmers to shift massive inventories of grain to the federal government.

State and local governments increased their purchases of goods and services 2½ percent in 1985, a somewhat smaller rise than in the preceding year. Most of the growth in expenditures last year reflected strong increases in construction outlays as states and localities continued their efforts to improve and expand basic public facilities. With the rise in expenditures exceeding the growth in receipts, the fiscal position of state and local governments weakened throughout the year; aggregate operating and capital account surpluses, which had risen to substantial levels in 1984, were virtually eliminated by the end of 1985.

Foreign Sector

After registering particularly sharp gains toward the end of 1984 and in the first two months of 1985, the dollar generally fell in international currency trading throughout the remainder of last year. By the end of 1985 the trade-weighted foreign exchange value of the dollar had fallen nearly 25 percent from its peak in February, retracing about half of the appreciation that had occurred since the end of 1980. The decline in the dollar in 1985 occurred against the backdrop of a narrowing of the differential between inflation-adjusted long-term interest rates in the United States and those in other industrial countries, which at least in part reflected the slowing of economic growth in the United States relative to growth abroad.

With the dollar still relatively strong, the external position of the United States continued to deteriorate last year. The widening gap between imports and exports boosted the current account deficit to $118 billion, compared with $107 billion in 1984.

The volume of merchandise exports declined in 1985. With U.S. prices relatively high and world supplies abundant, agricultural exports fell abruptly. Exports of nonagricultural goods were essentially unchanged as the continuing effects of the dollar's earlier appreciation, combined with relatively moderate growth in other industrial countries, on average, limited the expansion of markets for U.S. products. Furthermore, economic growth in developing nations recovered only a bit, as many countries continued to face difficult debt-servicing problems externally and strong inflationary pressures at home.

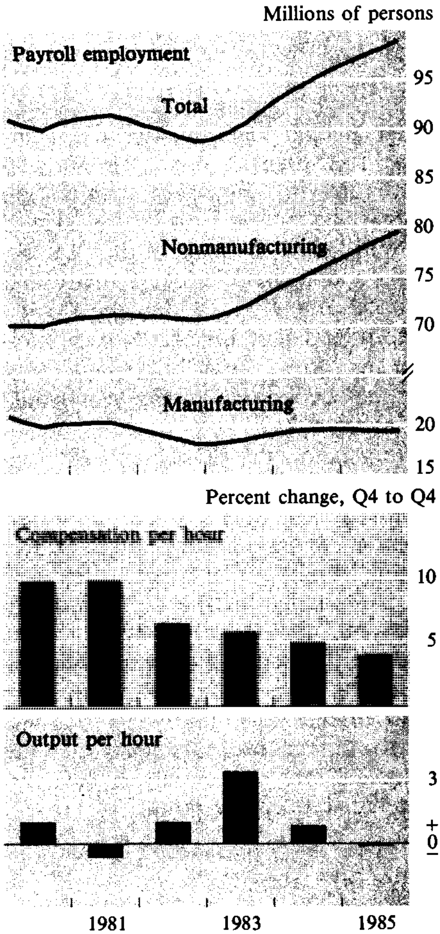
Merchandise imports continued to rise in 1985, increasing about 3½ percent in real terms over the 1984 level. Imports of consumer goods rose strongly while imports of capital equipment and industrial materials posted smaller increases, and oil imports declined. Although prices of imported goods fell for the year as a whole, some firming in the prices of manufactured imports became apparent toward the end of the year, reflecting the effects of the decline in the value of the dollar.

Labor Markets

With the economy continuing to expand, developments in labor markets remained generally favorable in 1985. Gains in employment exceeded the growth of the labor force, causing the unemployment rate to drift down over the year. Labor force participation maintained its upward trend; women continued to enter the workforce in large numbers, in part responding to expanding job opportunities. Over all, the number of persons employed relative to the population rose to a record level.

Nonfarm payrolls expanded 3 million in 1985, somewhat below the unprecedented hiring rate during the first two years of the recovery. Although growth in aggregate employment continued, the composition of the gains reflected the unevenness of the current

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.

expansion. Employment in the trade and service sectors accounted for more than two-thirds of the growth in payrolls last year. Government employment rose nearly one-half million, primarily because of increased payrolls of state and local governments. By contrast, the weak expansion of output in manufacturing resulted in some trimming of employment over the first three quarters of the year. Although an upturn in manufacturing jobs began in the fall, employment in that sector was down about 180,000 over the year.

Wage increases remained restrained in most segments of the labor market in 1985, despite a further reduction in the unemployment rate. Hourly compensation in the private sector, as measured by the employment cost index, rose about 4 percent, 1 percentage point less than in 1984. Nearly all of the deceleration of compensation per hour last year reflected a slowing in the growth of fringe benefits; wage rates increased at about the 1984 pace. To a large extent, the recent slowing in the growth of benefits has resulted from lower health care expenses for employers, as cost-sharing arrangements shifted greater responsibilities to employees and programs to contain hospital costs became more widespread.

Meanwhile, labor productivity was nearly unchanged in 1985, after increasing substantially earlier in the recovery. When viewed over a longer period, the underlying trend in productivity in recent years appears to have improved a little from the very low pace of the 1970s, but it has remained well below the pace earlier in the postwar period. Management and workers have responded to a more competitive environment by modernizing plant and equipment, improving operational efficiency, and making work rules more flexible. Unit labor costs in the nonfarm business sector rose 4 percent in 1985, a larger increase than during the previous two years but well under the growth of the early 1980s.