

The Economy in 1988

The U.S. economy completed a sixth year of expansion in 1988. Real gross national product rose about 2¾ percent over the course of the year, the number of jobs increased more than 3½ million, and the unemployment rate remained on a downward course, closing the year at 5.3 percent, its lowest level in 14 years.¹ Progress also was made toward restoring external balance, as the merchandise trade deficit fell sharply.

The year began on a note of uncertainty. The sharp break in the stock market in the fall of 1987 had raised concern that the economy might falter, and some signs of weakness did emerge around the start of 1988. By early spring, however, it became clear that the expansion still had considerable vigor, particularly from rising exports and a boom in capital spending. Households, meanwhile, adjusted fairly readily to the loss of wealth in the stock market, and consumer spending rose at a strong pace throughout the year. Toward the end of the year, net exports and capital spending softened, but there was enough impetus from other sectors to keep real GNP on a firm upward course.

The rate of inflation, which had picked up in 1987, remained somewhat higher in 1988 than in earlier years. The step-up in 1987 had resulted mainly from a rebound in the price of oil and the passthrough of higher prices for imports. In 1988, by contrast, extra price pressures reflected the effect of drought on the price of food and, more generally, a widespread pickup in labor costs in the domestic economy.

The rise in real GNP in 1988 would have been about 3½ percent but for a severe drought, one of the worst of this century, which caused huge losses of farm output. These losses accounted for most of the slowdown in GNP growth that occurred after the first quarter of 1988. Fortunately, inventories of farm products had been sizable coming into 1988, and a drawdown of stocks helped to buffer households and others from the disruption to output. Within the farm sector, the drought strained the finances of some producers, but the financial condition of many others was not seriously affected, and the sector as a whole remained stronger fundamentally than in the first half of the 1980s, when the boom of the previous decade was unwinding.

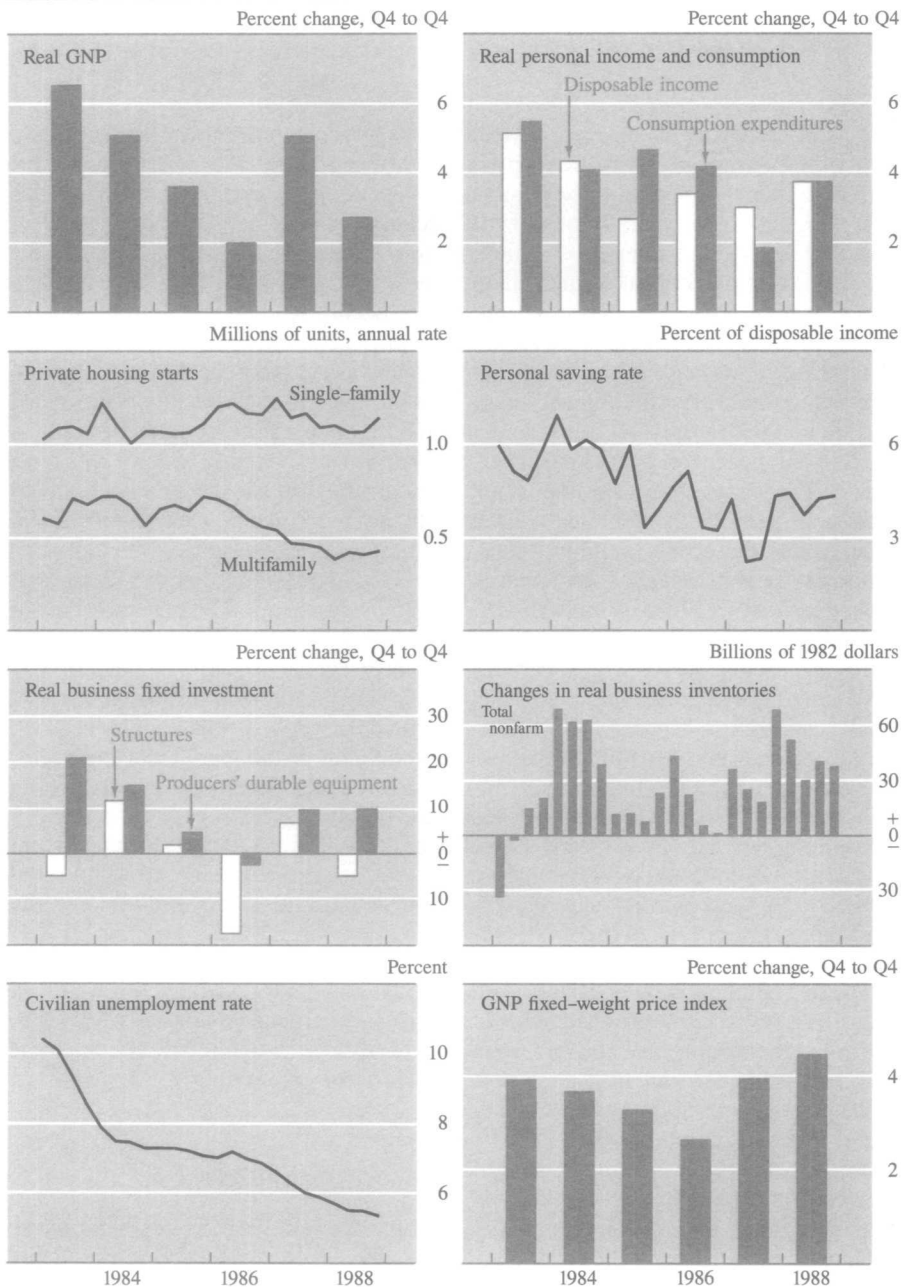
In most of the nonfarm economy, the growth of activity was robust in 1988. Production in the manufacturing sector increased 5½ percent, nearly matching the previous year's gain, and factory employment rose sharply. Employment also continued to grow rapidly in retail and wholesale trade and among the providers of business and health services. However, oil drilling activity, which had turned up in 1987 when oil prices were rising, weakened over 1988, intensifying economic stresses in some parts of the country.

The Household Sector

At the start of 1988, concern about the possible effect of the stock market break on the real economy centered on the household sector. The drop in share values had pared roughly one-half trillion dollars from household wealth, and the

1. Except where noted, percent changes are over the four quarters of the year indicated.

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.

degree to which spending would be cut in response to this loss of wealth was not clear.

In the event, the loss of wealth may indeed have trimmed consumer demand. The personal saving rate rose after the crash, and over the next year it was on average about 1 percentage point higher than in the year preceding the crash. But with exports and capital investment booming, the growth of jobs and real incomes remained strong in 1988, and the uncertainties spawned by the crash soon gave way to renewed optimism among households. Thus, after the initial jump in the saving rate, real consumption expenditures grew at about the same pace as the trend in real after-tax income; the rise over the year was about 3¾ percent.

Consumer spending for durable goods was brisk in 1988. The unit sales of light trucks and vans surged in 1988, maintaining the exceptional strength that has been evident during the current expansion, and the sales of domestically produced automobiles moved up a bit from the 1987 pace. Among the household durables, real outlays for furniture and appliances, which had slowed in 1987, increased 7 percent during 1988, renewing the strength that had been evident over the 1983–86 period.

Real residential investment fell slightly in the first half of 1988; but it turned up in the second half and by the fourth quarter was a little above the level of a year earlier. Starts of multifamily housing units, which had slumped in 1987, fell further in the first quarter of 1988 and then flattened out over the remainder of the year. In the single-family sector, starts declined somewhat in the first half of 1988 but then rebounded; activity in the fourth quarter was the highest since the third quarter of 1987. By historical standards, these swings in single-family starts were relatively mild; indeed, in comparison with the boom and bust

cycles of the 1970s and early 1980s, activity in the single-family market was stable over the entire period from 1983 to 1988. Nonetheless, total housing starts in 1988 were down sharply from earlier years of the expansion because of the big drop in construction of multifamily units.

The Business Sector

Virtually all indicators of business activity exhibited strength in 1988. Business sales, in nominal terms, rose 9 percent over the year. Hiring was brisk in most sectors, and operating rates rose further; in the industrial sector, capacity utilization at the end of 1988 was at its highest level since 1979. Corporate profits remained healthy.

A surge in spending for business equipment that had begun in 1987 extended through the first half of 1988, when outlays grew in real terms at an annual rate of about 20 percent. The surge was led by sizable investment in high-technology items—computers, communication equipment, and the like—but outlays for other types of equipment also were strong. The rise in equipment spending slowed after midyear, and some weakness became evident toward the end of the year. At year-end, however, most indicators suggested that the underlying trend in equipment spending still was positive.

Business spending for new construction declined in 1988, reversing the moderate increase of the previous year. Commercial construction, the biggest item in the total, continued to be restrained in 1988 by the big overhang of vacancies that grew out of the building boom of the mid-1980s. Gas and oil drilling, following the lead of oil prices, fell back from the pace of late 1987, but remained above the lows of 1986. Construction of buildings for industrial use was little changed over 1988; although

capacity utilization was high in manufacturing, many producers appeared to be limiting their needs for additional space by shifting toward technologies that use more compact equipment, by economizing on inventories, or by conserving on space in other ways.

Inventory investment, which had been sizable in late 1987, moderated in 1988, and with sales on an upward trajectory, stock overhangs were not a problem for most businesses. In manufacturing, stocks grew more rapidly in 1988 than they have in recent years, but much of the accumulation was in industries in which orders and shipments also were generally strong; the ratio of inventories to sales for all of manufacturing moved down during the year from the already low levels of late 1987. In retail trade, concern about a possible overhang of the stocks of nondurables eased during the year, and stocks at year-end did not appear to be burdensome. By contrast, auto dealers' stocks rose sharply in the fourth quarter; at the end of the year, auto manufacturers seemed likely to turn toward enhanced sales incentives and, perhaps, a lower assembly rate in an effort to pare inventories. For all of manufacturing and trade combined, the ratio of inventories to sales varied little over the course of 1988 and was near the lower end of the range in which it had been since the business expansion began.

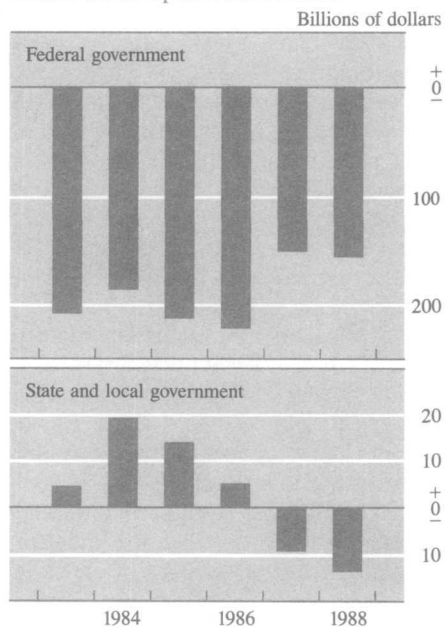
The Government Sector

Budgetary constraints limited the growth of government purchases in 1988, both at the federal level and among many state and local governments. The federal government's purchases of goods and services—the part of federal spending that adds directly to GNP—fell 3½ percent in real terms from the fourth quarter of 1987 to the fourth quarter of 1988. Roughly two-thirds of the decline re-

flected a drought-induced reduction in the farm inventories owned or financed by the Commodity Credit Corporation (CCC), a reduction that is counted as a negative federal purchase. Excluding this inventory swing, federal purchases were down about 1 percent over the year—the first decline since 1976. Over the eight years preceding 1988, real federal purchases other than those of the CCC had risen at an average pace of nearly 5 percent, considerably faster than the growth of real GNP. The downturn in 1988 reflected cuts in the defense area; other non-CCC federal purchases rose somewhat over the year.

On a budget basis, total federal outlays, which are almost three times as great as

Government Surpluses and Deficits



The data on the federal government are for fiscal years. They are on a 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.

federal purchases alone, were up 6 percent for fiscal 1988 as a whole. Entitlements, demands on deposit insurance agencies, and net interest payments all rose. Meanwhile, the growth of federal receipts slowed in 1988 from the rapid pace of the previous year. Receipts from social security taxes rose more than 10 percent, in part because of a rate increase in January 1988. The growth in receipts from personal income taxes slowed, however, as increases in employment and nominal incomes were offset by final reductions in income tax rates legislated in 1986. The federal budget deficit in fiscal year 1988 was \$155 billion, slightly above the level of the previous year.

The purchases of goods and services by state and local governments rose close to 3½ percent in real terms over the four quarters of 1988, more than in 1987 but less than the average rate of growth over the preceding three years. Spending for construction was little changed for 1988 as a whole, although some pickup was evident in the fourth quarter. Employment in the state and local sector increased 350,000 during 1988; a large share of the rise was among the teachers and other school workers needed to meet the growth in the number of elementary students.

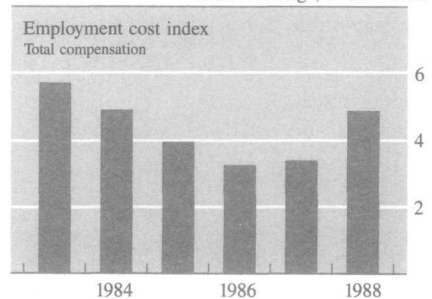
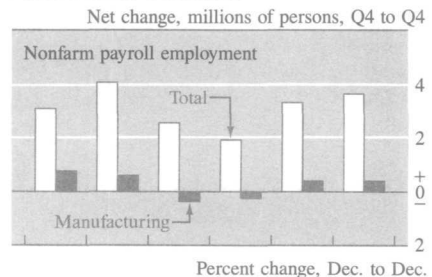
The Labor Markets

The rise in the number of jobs during 1988 was somewhat above that of 1987 and brought the total increase in payroll employment since late 1982 to about 18½ million. Virtually all parts of the economy shared in last year's gain. Manufacturing jobs rose 400,000; construction employment was up 300,000; close to 1 million new jobs were created in retail and wholesale trade; and service employment grew by 1.3 million jobs. Except for a brief slowdown in the

summer, employment expanded strongly throughout the year.

The continued rise in employment last year led to a tightening of labor markets and called attention to limits on the potential growth of the supply of labor and of output. Growth of the working-age population has slowed in the 1980s, and the increase during 1988 was the smallest annual rise in more than two decades. This slowing of population growth in the 1980s has led in turn to a more moderate rate of growth in the labor force, even as the rate of labor force participation, especially for adult women, has continued to rise. A big boost to output during the expansion has come from the hiring of unemployed workers; however, with the unemployment rate at less than 5½ percent at the end of 1988, the labor force was more fully utilized

Labor Market Conditions



Payroll employment covers the total nonfarm sector; the employment cost index is for private industry, excluding farm and household workers. The data are from the Department of Labor.

than at any time in the last decade and a half.

The tightening of labor markets in 1988 was associated with a pickup in the rise of wages and labor costs. The employment cost index for wages and salaries in the private nonfarm sector increased a bit more than 4 percent over the year—almost 1 percentage point more than in 1987. The pickup was most pronounced among white collar workers and in the service-producing industries. The cost of benefits provided to employees rose 6¾ percent over the year, nearly twice the increase of 1987; the rise reflected both the hike in the payroll tax at the start of 1988 and a surge in the cost of health benefits. Total compensation per hour—wages and salaries plus benefits—rose nearly 5 percent over the four quarters of 1988, after two years in which the annual increases had been in the neighborhood of 3¼ percent.

Productivity gains slackened somewhat in 1988. The rise in output per hour in the nonfarm business sector over the four quarters of the year was only 0.7 percent—about ½ percentage point below the average over this decade. This slippage in productivity growth in 1988, combined with the faster rate of increase in hourly compensation, resulted in a 4 percent rise in unit labor costs in the nonfarm business sector over the four quarters of 1988—well above the average rate of increase during the previous five years.

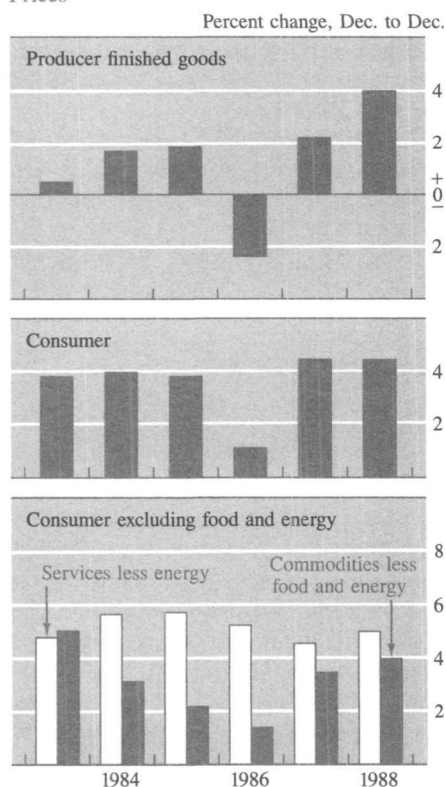
Price Developments

The broader measures of prices—including the GNP price measures, the producer price index, and the consumer price index (the latter two measured from December to December)—all showed inflation to be in a range of 4 to 4½ percent in 1988. Except for the CPI, which had moved up at a 4½ percent rate in 1987, these measures showed some acceleration from

the previous year, and all of them—including the CPI—rose more rapidly than in earlier years of the expansion. In contrast to 1987, when the indexes were boosted by a rebound in energy prices and rising prices for imports, the inflationary pressures in 1988 were augmented by larger increases in labor costs in the U.S. economy and the drought's influence on agricultural prices.

The drought's effects on retail food prices appeared quickly, with increases on a wide variety of items evident by summer. Over the year as a whole, the increase in consumer food prices was 5¼ percent—about 2 percentage points above the average of the preceding five years.

Prices



The data are from the Department of Labor.

Energy prices at the consumer level, particularly for oil and gasoline, had risen sharply in 1987 but were little changed in 1988—a pattern that resulted mainly from the continued gyrations in world oil markets. The price of crude oil moved lower for much of 1988 as the efforts of OPEC to restrain production unraveled. In late 1988, however, a new agreement by OPEC to limit production, coupled with production shortfalls in non-OPEC countries and higher-than-expected oil consumption, caused spot prices to rise sharply once again, back toward the upper end of the range in which they generally have been since the summer of 1986.

Price increases for goods and services other than food and energy were larger in 1988 than in 1987. The pickup, while fairly moderate, was widespread and probably reflected, in large part, the acceleration in hourly compensation and unit labor costs. By contrast, the pressures from rising import prices appeared to be a bit less pronounced than in 1987. Even so, higher prices for imports probably were an influence in some areas; the retail prices of apparel, for example, rose nearly 5 percent for the second year in a row. The price increases for industrial commodities slowed in 1988 after steep increases during 1987; by most measures, however, the year-to-year rate of rise in these prices remained somewhat above that of inflation in general. The producer prices of intermediate inputs, excluding food and energy, rose more than 7 percent during 1988, reflecting the high levels of capacity utilization in a number of industries, as well as the tightening of labor markets. ■