# The Business Situation

Signs of weakness in the United States economy have multiplied in recent weeks. Industrial production fell sharply again in November, with the decrease extending far beyond the constricting effects of the coal strike, and home building weakened further. Moreover, both business and consumer demand have continued to slacken. New orders for durable goods and retail store sales dropped for the third consecutive month, and single-family home sales declined as well. With both production and demand declining, labor market conditions have deteriorated rather sharply. The unemployment rate rose in December to 7.1 percent of the civilian labor force, the highest rate in over thirteen years.

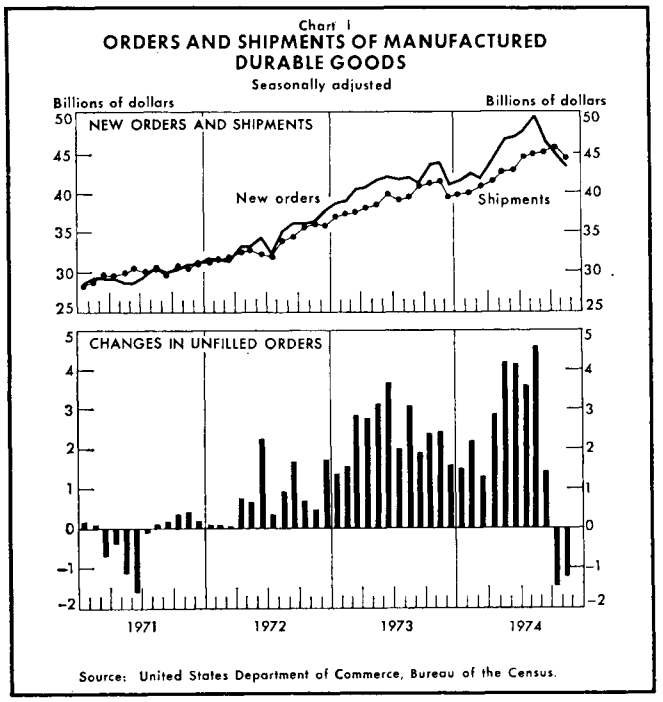
Prices have continued to increase at annual rates in the double-digit range, although at the wholesale level the recent rates have been significantly lower than earlier in 1974. Wholesale industrial prices rose at an annual rate of 10.3 percent in November, confirming the deceleration that began in the fall of 1974; earlier in the year, the index of wholesale industrial prices had climbed at a 32.9 percent annual rate. The consumer price index rose at a 10.8 percent annual rate in November, down slightly from the average over the previous ten months. In December, there were several hopeful signs in the price picture. The percentage of purchasing managers reporting higher prices continued to move lower, and at the retail level there were widespread reports of unusual pre-Christmas sales.

## INDUSTRIAL PRODUCTION, INVENTORIES, AND DURABLES ORDERS

The industrial production index of the Board of Governors of the Federal Reserve System registered a 2.3 percent drop in November. Following a sizable decline in October, the November fall pushed the index to a level 4.3 percent below its peak in November 1973. Nevertheless, the total reduction in the output of the industrial sector since November 1973 has amounted to only about half of the decline registered in the last two recessions.

The November drop in industrial production reflected, in part, the effects of the coal strike and the cutbacks in automobile assemblies. The strike by members of the United Mine Workers union accounted for most of the 5.2 percent drop in output at the nation's mines. In addition, the strike hampered those industries dependent on coal. Domestic coal is used to produce coke, a material required for pig iron production and, therefore, steel production. Thus, a good part of the 4.1 percent decline in the iron and steel production index is probably attributable to the strike. Another major user of domestic coal is the electric utility industry which accounts for almost two thirds of total coal usage. Therefore, some part of the 1 percent fall in the output of utilities, which includes electricity production, probably also reflects the coal strike.

During the past several weeks the automobile manufacturers have tried to bring production into line with sagging sales. Layoffs, beginning in late November, cut domestic auto assemblies for that month as a whole to an annual rate of 7 million units, down from an 8.3 million unit rate in October. (During 1973, a record year, the production rate averaged 9.6 million cars.) Nevertheless, production continued to outpace sales of domestic-type autos, which fell further during November to an annual rate of 5.7 million. This was the lowest sales rate since December 1970 when dealers' stocks were depleted in the wake of the two-month General Motors strike. Consequently, inventories of unsold new cars rose further in November to 1.97 million units. In relation to sales, inventories in November amounted to 106 days' supply, the highest inventory-sales ratio in more than ten years. Auto manufacturers have cut production further by temporary plant closings, reduced assembly-line speeds, and large-scale layoffs. As a result, production of passenger cars in December dropped to an annual rate of only 5.3 million units.




While the coal strike and the automobile industry slump contributed to the November decline, production in other sectors dropped as well. Large declines occurred in the output of nonautomotive consumer durables, and business equipment production, which had remained strong through October, fell 1.1 percent. Output of construction products dropped 2.8 percent in November, the sixth straight monthly decline, and production of most other durable and nondurable industrial materials also moved lower. As of November, business equipment output was one of the few components of industrial production that was still above the level of a year earlier.

The continued deterioration in the economy was also evident from the third consecutive monthly decline in new orders for durable goods received by manufacturers (see Chart I). The 3.8 percent drop in November brought new orders to $43.4 billion at an annual rate, 12.3 percent below the peak August pace. The latest decline in bookings was mainly in primary metals, machinery, and transportation equipment. For nondefense capital goods as a whole, bookings were down 4.8 percent over the month to $10.8 billion, the lowest level since September 1973. Unfilled orders declined for the second consecutive month, after rising steadily for three and a half years.

It is expected that the figures, when available, will show that production remained weak in December partly because of the lingering effects of the coal strike. In addition, the decline in new orders and the large overhang in inventories are likely to dampen the level of output. Total business inventories rose by $5.6 billion in October, the largest increase so far this year; about one third of the advance was attributable to an increase in automobile dealer inventories. With overall business sales rising by less than $1 billion in October, the ratio of inventories to sales increased substantially. At 1.54 months of sales, the ratio was the highest in almost two and a half years and represents a significant increase from rates of 1.51 months in September and 1.48 in August. Moreover, the strong advance in the ratio occurred despite recent changes in accounting practices that effectively lowered book-value estimates of inventories at some firms.

## PERSONAL INCOME, RETAIL SALES, AND RESIDENTIAL CONSTRUCTION

Personal income fell $2.2 billion, or 0.2 percent in November, as mounting layoffs and the coal strike reduced factory payrolls over the month. Wage and salary disbursements in manufacturing declined by $5.2 billion, the largest drop since the General Motors strike in October 1970. Over the year ended in November, personal income rose by 7.5 percent, substantially less than the price level.

Consumer demand has weakened materially in recent months, reflecting the decline in real income and growing employment uncertainties. Retail sales dropped by $0.6 billion in November, an amount equal to the average decline in the previous two months. Slow sales at automobile dealers accounted for much of the November decrease, but business was down as well in furniture and appliance stores, apparel shops, gasoline stations, and equipment supply shops, on a not seasonally adjusted basis. Compared with a year ago, total retail sales were up only 5.3 percent, indicating a substantial decline in real terms (see Chart II which shows retail sales deflated by the consumer price index).

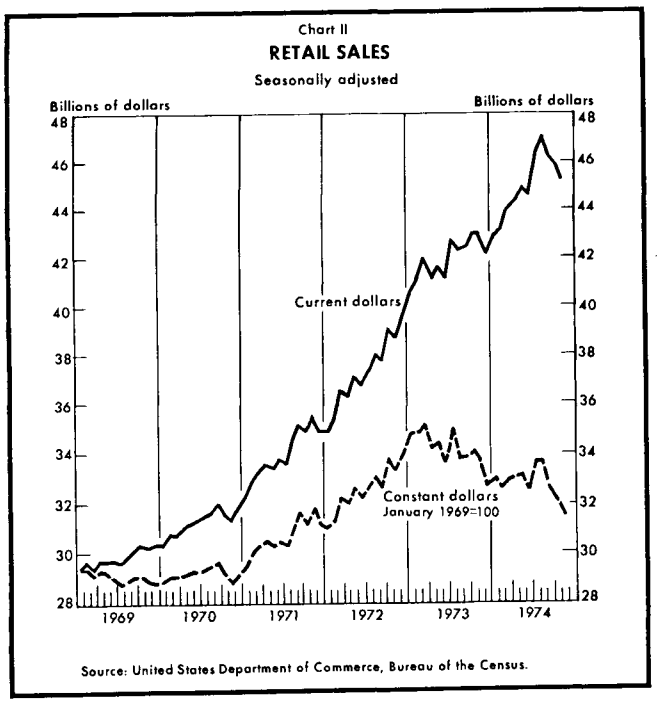
The home-building slump worsened in November. Housing starts dipped to 990,000 units at an annual rate, an eight-year low, and new building permits were issued at the lowest rate since the Department of Commerce began collecting the data in 1959. The seasonally adjusted pace of housing starts in November was 10.5 percent below the previous month and down 40.9 percent from a year earlier. A sharp drop in the construction of rental apartments and condominiums accounted for most of the latest decline. In sum, new construction of buildings

with two or more units has fallen to 28 percent of its November 1973 level and is at the lowest rate since March 1960.

Conditions in the market for new one-family homes remained depressed also. Single-unit housing starts in November were 16.4 percent below the rate of a year ago. The slowing in the pace of new home buying has contributed to the recent declines. In October, the number of new one-family homes sold fell to 410,000 units at an annual rate, 18.8 percent below October 1973. While the inventory of new homes for sale declined in October to the lowest level since December 1972, the ratio of homes for sale to homes sold remained at historically high levels.

## PRICES

Severe inflation persists at the retail level, as the prices of commodities and services continue to advance on a broad front. In November, total consumer prices, adjusted for seasonal variations, rose 10.8 percent at an annual rate. Food prices jumped at a 16.5 percent annual rate over the month, largely as a result of soaring sugar costs. In the past year, the retail price of sugar has increased by about 185 percent, reflecting growing world demand and poor harvests. Since the November price survey, however, retail sugar prices have reportedly stabilized and even declined slightly.



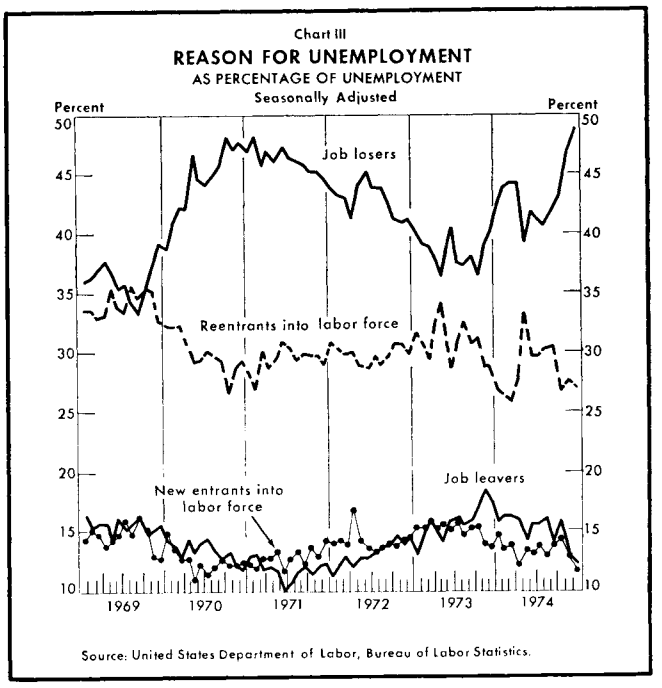

Price increases were widespread among other consumer goods in November. The index of all commodities less food rose at a 9.3 percent rate. Although faster than the 6.8 percent annual-rate advance in October, the November pace was significantly below the 15 percent rise in the first nine months of the year. Higher clothing prices accounted for about one fourth of the November increase, with prices for appliances, coal and fuel oil, and other nondurables continuing to move ahead rapidly. Gasoline prices fell for the fourth consecutive month but were still 26 percent above a year ago. There were widespread reports of unusual pre-Christmas sales at retail stores during December, which should have a favorable impact on the December price figures. However, it remains to be seen whether this signals a trend toward more moderate price behavior at the retail level.

Wholesale prices advanced at a 14.6 percent annual rate in November, about half the October pace, as the rate of increase in prices of farm and food products slowed from the very rapid 61.5 percent annual rate recorded in October. Despite the slowdown, the index of farm products and processed foods and feeds continued to soar, advancing at almost a 30 percent annual rate. The November increase was attributable largely to sugar and confectionery price rises.

The November wholesale price statistics for nonfood commodities showed further tentative evidence of a deceleration in inflation. Wholesale industrial prices rose at a 10.3 percent annual rate in November, less than the September and October rates and one third the rate of advance in the preceding eight months of the year. Moreover, price increases have become less widespread, especially for goods at the beginning stages of fabrication. After rising 47.1 percent at an annual rate in the first seven months of the year, the index of crude materials has declined by 0.7 percent at an annual rate in the last four months. More recently, the rate of advance in prices of intermediate materials has slowed. In the three months ended in November, the index of intermediate materials less materials for food manufacturing and manufactured animal feeds moved up 10.6 percent, compared with a 37.4 percent pace in the preceding eight months. However, finished goods prices continued to advance rapidly, increasing at an average annual rate of over 20 percent in the last three months.

During a period of general inflation, many prices rise in any month, but as inflation subsides the percentage of prices rising generally declines. In this regard, it is interesting to note that in recent months increasingly fewer

purchasing managers have been reporting higher prices on purchased materials. Each month, the National Association of Purchasing Management, Inc., surveys its members on purchased materials prices, among other things. In November, only 49 percent reported higher prices, whereas 95 percent had reported higher prices in March 1974. According to the latest report, the proportion dropped further in December to 43 percent.




## EMPLOYMENT

The unemployment rate jumped 0.6 percentage point to 7.1 percent in December, the highest rate in over thirteen years. The latest spurt in the unemployment rate was widespread, with the jobless rate for adult men and adult women increasing by 0.5 percent and 0.6 percent, respectively. White collar workers had an unemployment rate of 4.1 percent in December, up from 3.7 percent in November and the highest rate since 1958 when the statistics were first collected. The jobless rate for blue collar workers increased to 9.4 percent in December from 8.2 percent a month earlier.

In December, the civilian labor force remained virtually unchanged; civilian employment dropped by 550,000 persons to the lowest level since September 1973. Over the last two months, the number of unemployed has risen by a substantial 1,022,000 persons, with job losers—those leaving their jobs involuntarily and persons on layoff—accounting for over 75 percent of the increase. As a result, the number of job losers as a percentage of the total number unemployed has risen from 43.2 percent in October to 48.8 percent in December, similar to rates resulting from the 1969-70 recession (see Chart III).

# The Business Situation

Economic activity in the nation contracted sharply in the fourth quarter of 1974, and the decline apparently continued in the opening weeks of the new year. Real gross national product (GNP) declined at a 9.1 percent annual rate, falling to a level about 5 percent below the peak recorded during the last quarter of 1973. At the same time, industrial production, which had earlier been holding up, dropped at a 12.1 percent annual rate in the fourth quarter. While much of the decline in industrial production is attributable to the large reductions in automotive output, the decrease in manufacturing activity was widespread and extended beyond the automotive sector. The deterioration in economic activity was reflected in a marked worsening in labor market conditions. The unemployment rate has registered a steep rise in recent months reaching 8.2 percent in January, with all major labor-force groups showing increases.

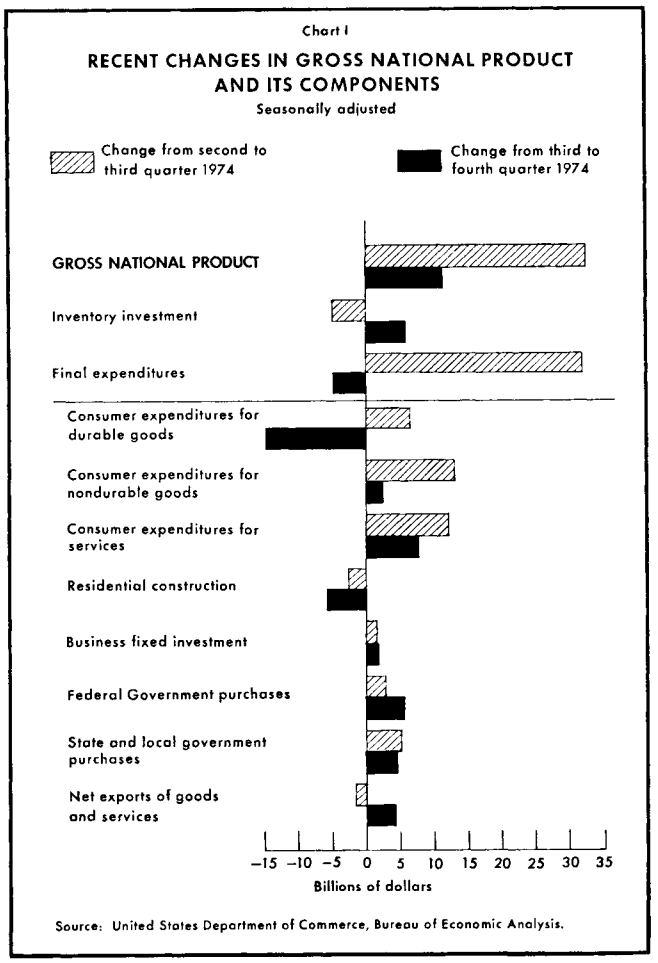
As outlined in his recent State of the Union message to the Congress, President Ford's proposed fiscal policy measures are aimed both at stimulating the economy and at increasing the nation's self-sufficiency in energy sources. On the one hand, to stimulate the economy, the President proposed a partial rebate of 1974 personal tax payments and a one-year increase in the investment tax credit. If adopted, these two measures would return about $16 billion to the private economy. On the other hand, higher taxes on petroleum and natural gas products were proposed as part of a program to reduce energy consumption as well as to boost domestic production. Toward these ends, the President proposed import duties on crude oil and refined petroleum products, an excise tax of $2 per barrel on domestic crude oil and an equivalent tax on natural gas, the decontrol of domestic oil prices, and a windfall profits tax on oil producers. However, to prevent the measures from being deflationary, the proceeds from these taxes are to be returned to the economy through several channels: changes in the personal income tax schedule, a cut in the corporate profits tax rate to 42 percent, cash payments to low-income persons to compensate them for higher energy costs, and revenue-sharing payments to state and local governments.

Inflation has slowed markedly at the wholesale level in recent months. In the fourth quarter, increases in wholesale industrial prices slowed to a 7.9 percent annual rate, a substantial decline from the 26 percent recorded in the previous quarter. Prices at the retail level have shown only a modest deceleration in recent months. Thus, the consumer price index increased at an annual rate of 9.8 percent during the fourth quarter, bringing its total climb for the year to 12.2 percent. In December, however, reflecting special pre-Christmas sales at many stores, the consumer price index rose at only a 7.9 percent rate, the slowest advance in many months.

## GROSS NATIONAL PRODUCT AND RELATED DEVELOPMENTS

According to preliminary Department of Commerce figures, the market value of the nation's output of goods and services increased by $11.7 billion during the fourth quarter of 1974 (see Chart I) to a seasonally adjusted annual rate of $1,428 billion. However, the observed expansion was attributable entirely to price inflation and, after correction for price change, real GNP in 1958 prices declined sharply at an annual rate of 9.1 percent (see Chart II). As a result, the real value of the nation's output at the end of 1974 was 5 percent below the peak attained at the end of 1973. The hardest hit sectors have been residential construction down 32 percent, consumer spending on durable goods off 12.6 percent, and business fixed investment down 7 percent. Other components have shown varying degrees of weakness.

Industrial production fell at a 12.1 percent annual rate during the fourth quarter (see Chart II). During the two previous quarters, it had recovered somewhat following its sharp decline during the oil embargo and, by September, industrial production was only 1.5 percent below its high of November 1973. However, starting in September, output was severely reduced in several sectors of the economy. Automobiles and related industries were hit the hardest, with the output of automobiles and parts falling back by 10.6 percent and iron and steel down by 3.3 per-




cent. However, the production of nondurable goods also fell by 3.4 percent and, reflecting some influence of the coal strike, output in mining and utilities was off by 1.7 percent. Hence, businesses used their capacity much less intensively than they had in the recent past. The index of industrial capacity utilization fell to 80.6 percent during the fourth quarter, compared with 88.5 percent during the third quarter and 92.3 percent at the end of 1973.

Although production was cut back substantially, the real value of business sales plunged at an even faster rate. As a consequence, businesses accumulated inventories—no doubt against their wishes, in light of sales experience—at a noticeably faster rate during the fourth quarter than they had earlier in the year. The real value of inventory investment was $9.1 billion, compared with an average of $7.9 billion over the first three quarters. Automobile inventories alone accounted for $4.5 billion of the advance, and at the end of 1974 automobile dealers held inventories equal to 94.8 days of sales, compared with only 68.5 days at the end of 1973. This change in auto stocks also accounts, in part, for the fact that the average level of all business inventories measured in constant dollars rose to 32.8 percent of real business sales measured at an annual rate, up from 30.3 percent at the end of 1973 (see Chart III).

Faced with substantial idle capacity, businesses have evidently begun to pare their expenditures on new capital goods. Business fixed investment measured at current market prices increased by only $1.8 billion during the fourth quarter (see Chart I), compared with an average increase of $3 billion during the first three quarters of the year. All of the increase was in structures where investment expanded by $3.3 billion. Investment in equipment actually declined by $1.5 billion even before adjustment for price changes. Correcting for inflation, business fixed investment fell 5.1 percent to $89.3 billion in 1958 prices, with outlays for structures rising $0.8 billion and expenditures on equipment declining by $5.6 billion. Moreover, the general weakening of economic conditions appears to be having a negative impact on the investment plans of business. The most recent Commerce Department survey of planned investment spending for 1975 indicates that businesses plan to spend only about 4.6 percent more on plant and equipment in 1975 than they did in 1974. These results are substantially lower than those of a September survey by McGraw-Hill, which projected a 12 percent jump in fixed investment expenditures. The McGraw-Hill survey also found that businessmen anticipated that capital goods prices would rise by approximately 12 percent during 1975. Therefore, as of September, planned real investment for 1975 was about the same as for 1974. However, if the price expectations reported by McGraw-Hill in September were still held in December, the findings of the recent Commerce survey would indicate that firms now plan a sizable net reduction in real investment during 1975.

Consumers' real disposable income continued to deteriorate during the fourth quarter, falling by 4.4 percent at an annual rate to $596.2 billion. The declining purchasing power was at least partly responsible for the sharp falloff in the volume of household consumption expenditures in real terms, which declined at an 11.9 percent seasonally adjusted annual rate—the largest quarterly drop in the postwar period. Most of the decline was concentrated in purchases of durable goods, which decreased 42.9 percent on an annual-rate basis. The typically more stable nondurables component declined at a 7.1 percent annual rate, while expenditures on services rose by 1.9

percent. In addition, recent surveys indicate that consumer confidence has receded to extremely low levels. The University of Michigan survey, based on interviews conducted during October and November, showed consumer confidence had fallen to its lowest level since the inception of the survey in the late 1940's. The Conference Board consumer confidence index is also at a record low of 39.9 percent, down 9 points from the September-October period. Both surveys indicated that intentions to buy houses, cars, and appliances were at new lows.

The combination of high interest rates and a pessimistic outlook among potential buyers led to another substantial decline in residential construction during the fourth quarter. The real value of building activity was down by 14 percent during the fourth quarter, after having already fallen 21 percent during the first three quarters of the year. New housing starts during the quarter were recorded at a 990,000 annual rate. This is only the second full quarter in which starts have averaged less than 1 million at an annual rate since 1946. While the recent decline in interest rates may stimulate this finance-sensitive industry, the data on new housing permits do not foreshadow an immediate recovery. Permits during the fourth quarter were at their lowest level since the series began in 1959.

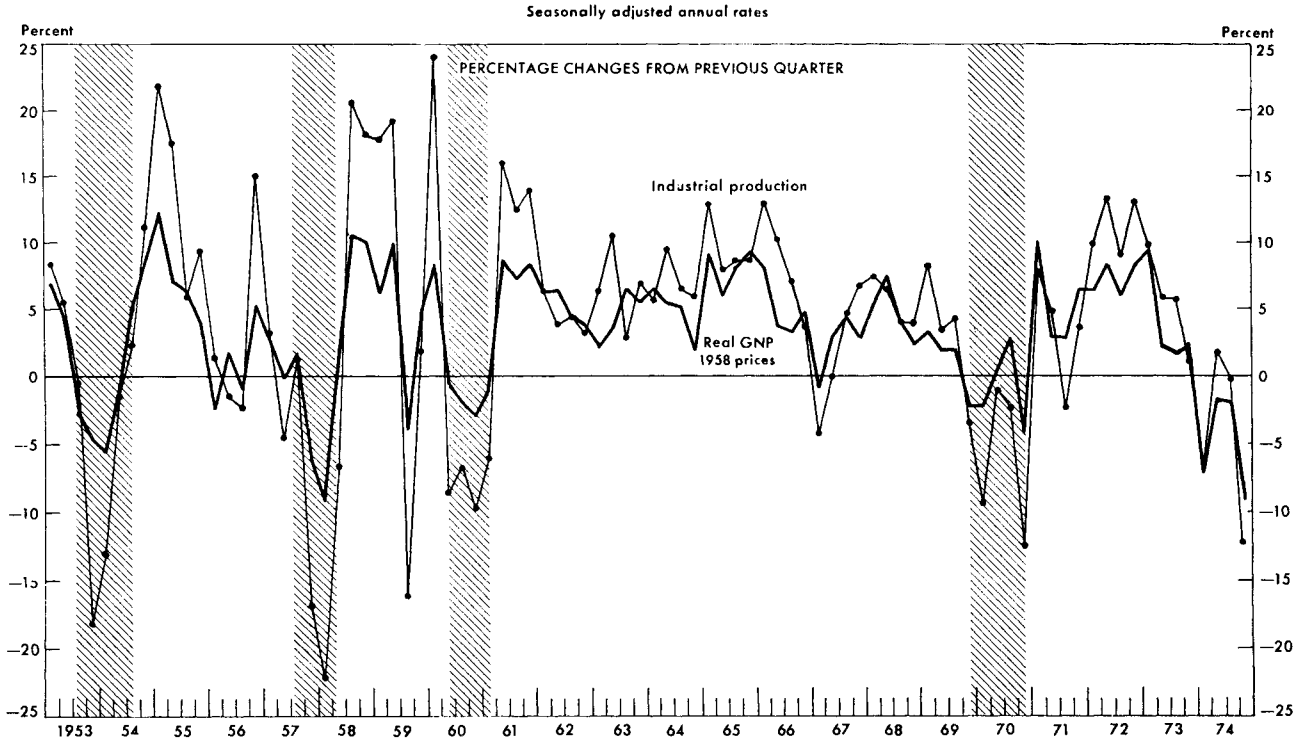
Higher prices accounted for the substantial boost in Government expenditures on goods and services during the fourth quarter. The Federal Government increased its spending by over $5.5 billion to an annual rate of $122.8 billion. Most of the advance was in defense spending, which rose by $5 billion. State and local governments increased their expenditures by $4.5 billion. In real terms, however, total government spending has remained virtually constant since the second quarter of 1974.

In contrast to the other major components of GNP, net exports increased by $1.6 billion in real terms in the fourth quarter, after having declined in two previous quarters.

Chart II

REAL GROSS NATIONAL PRODUCT AND INDUSTRIAL PRODUCTION

Seasonally adjusted annual rates




Note: Shaded areas represent recession periods, indicated by the National Bureau of Economic Research chronology. The dates of the 1969-70 recession are tentative.

Sources: United States Department of Commerce, Bureau of Economic Analysis, and Board of Governors of the Federal Reserve System.

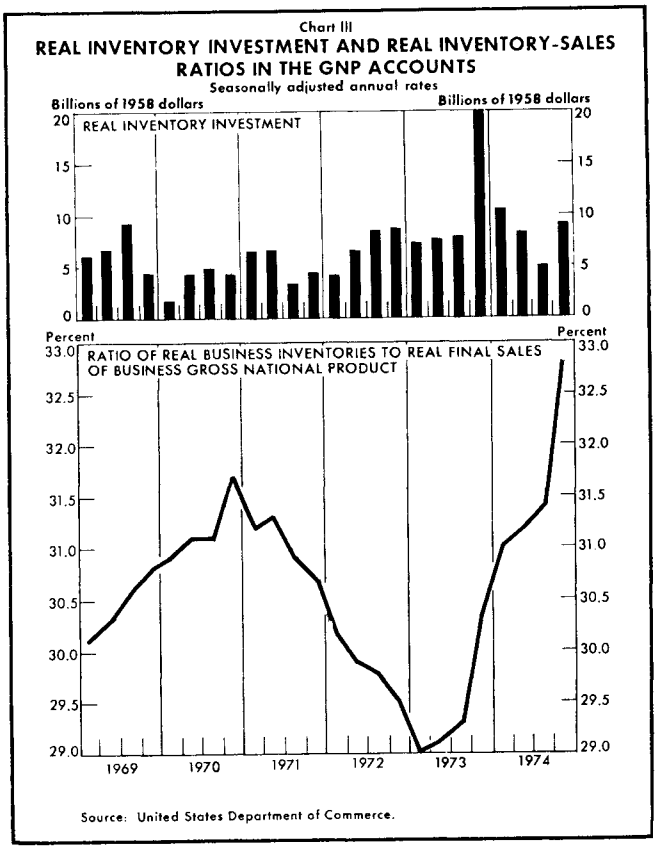
## PRICE DEVELOPMENTS

Despite signs of an improving price outlook, prices of final goods and services as measured by the implicit GNP price deflator rose at a 13.7 percent annual rate in the fourth quarter, up somewhat from the 11.9 percent growth rate recorded in the previous quarter. However, this measure appears to have overstated the extent of inflation to some degree. Thus, the fourth-quarter acceleration reflected both the Federal pay raise in October and the change in the composition of output brought about mainly by the drop in gross auto product. The fixed-weight deflator for private GNP increased at a 12 percent annual rate in the fourth quarter, down slightly from the 13.2 percent growth rate in the previous three-month period.

The consumer price index rose at a 9.8 percent annual rate in the final three months of 1974, its slowest quarterly rate of the year. This slowdown occurred despite an acceleration in the advance of retail food prices to a 13.8 percent rate, up from 11.7 percent during the third quarter. The prices of all commodity items except food rose at a 7.1 percent annual rate, well below the third quarter's 15.3 percent rate and less than half the average rate of increase during the first nine months of the year. Service prices in the fourth quarter rose at a 10.5 percent rate, just slightly less than the 11.3 percent average for the year as a whole.

At the wholesale level, however, there has been a substantial moderation in the rate of inflation. The wholesale price index advanced at a 12.7 percent annual rate in the final three months of the year, down from 31.3 percent during the third quarter and an average of 21.5 percent for the first nine months of the year. In December, wholesale prices actually declined at a 5.9 percent annual rate. For the quarter as a whole, the deceleration of prices was most noticeable among industrial commodities, which increased at a 7.9 percent annual rate, down from 25.7 percent in the third quarter. Moreover, this slowdown was quite broadly based, showing up in a large number of commodities including textiles, fuels, and paper products. The prices of farm products and processed foods and feeds rose at a 20.3 percent pace during the final quarter, well below the 49.3 percent rate of the third quarter. Viewed in combination with recent forecasts of larger harvests in the forthcoming season, this sharp fallback in the rate of inflation may signal a general weakening of farm price increases.

To some extent, the relief in industrial prices represents a working-forward of declines in raw materials prices, which have been under way for some months. The spot prices of raw industrial commodities declined 3.6 percent during the third quarter and by an additional 17.6 percent in the fourth. During the same period, increases in the wholesale prices of intermediate materials, excluding food and feeds, dropped from an 8.5 percent rate in the third quarter to 3.3 percent during the fourth.




## WAGES, PRODUCTIVITY, AND EMPLOYMENT

The cost of production continued to rise rapidly during the fourth quarter of 1974, as the compensation paid to labor increased while labor's productivity declined. Compensation per hour worked in the private sector of the economy increased at a 9.3 percent seasonally adjusted annual rate. At the same time, output per hour worked declined at a 5.3 percent rate. This productivity decline, coupled with the higher compensation rates, caused unit labor costs to increase at a 14.7 percent annual rate.

The effective wage of labor covered by collective bargaining increased at a 6 percent annual rate during the fourth quarter, bringing the total increase for 1974

to 9.2 percent. By comparison, the wage gain of contract labor in 1973 was 7 percent. Of the 1974 increase, 4.6 percent resulted from contracts negotiated during the year, 2.6 percent came from previous settlements, and 1.9 percent is attributable to cost-of-living escalator provisions. According to preliminary data from the Bureau of Labor Statistics, collective bargaining agreements—covering 5,000 or more workers—that were negotiated during the fourth quarter of 1974 called for first-year wage and fringe benefit increases of 14.8 percent. This is somewhat higher than the 11.9 percent written into contracts during the third quarter, and well above the 9.3 percent average during the first three quarters of the year. Over their entire lives, new contracts in the fourth quarter will provide average annual increments of 8.7 percent in wages and benefits, compared with 7.1 percent during the preceding three quarters.

Reflecting the sharp decline in the production of goods and services, the seasonally adjusted civilian unemployment rate rose to a postwar record of 8.2 percent in January. The increase in unemployment, up from 7.2 percent in December, was felt by all age groups in the labor force. However, it was particularly pronounced among teenagers. The jobless rate among workers under twenty years of age increased to 20.8 percent in January, while unemployment among prime-age workers, twenty-five years and older, rose to 5.7 percent. Looking at the breakdown by job categories, the January unemployment rate for white-collar workers was 4.6 percent, while the blue-collar rate was 11 percent.

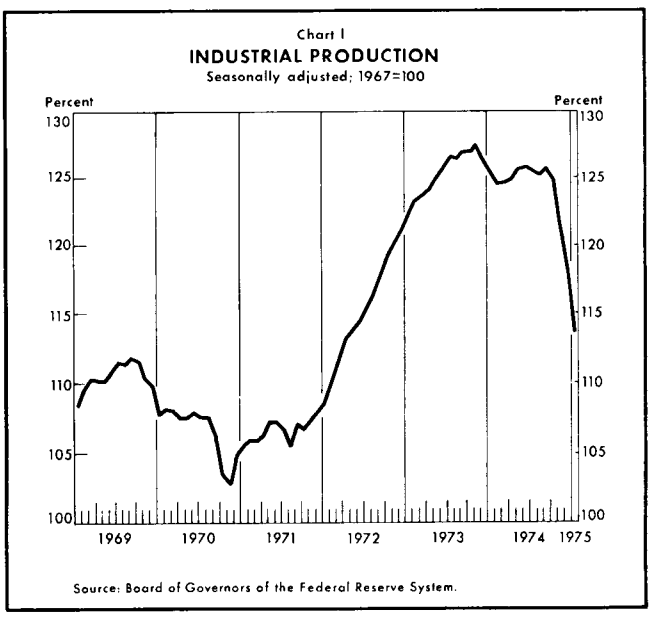
# The Business Situation

By nearly every measure, the economic contraction has deepened further in the new year. Industrial production fell 3.6 percent in January, and new orders for manufactured durable goods declined precipitously. Moreover, net new capital appropriations by the nation's 1,000 largest manufacturers were reported to have decreased in the fourth quarter of 1974 after several years of heady gains. There was a slim increase in personal income in January, but it was largely attributable to higher transfer payments, as income from salaries and wages declined $0.9 billion. Labor market conditions have continued to reflect the increasingly pervasive slack, with industrial work forces substantially reduced. Nevertheless, the economy's performance is not completely devoid of hopeful signs. Residential construction recovered a bit in January, as housing starts registered a slight gain, and retail sales posted a second consecutive monthly increase.

The reduced pace of economic activity in recent months has succeeded in dampening inflation, and the price outlook is more encouraging than it has been in some time.* Wholesale prices declined in February for the third time in as many months, led by sharp reductions in the prices of farm products and related items. While industrial wholesale prices increased, the rate of advance was considerably below the inordinately rapid rate observed throughout most of 1974. Furthermore, sluggish demand and weak materials prices have begun to exert a restraining impact on finished goods prices. At the retail level, the vigorous promotional efforts which sparked retail sales were accompanied by some price reductions, including the much-publicized price rebates on automobiles and some consumer appliances. Partly as a result, the consumer price index in January recorded its smallest monthly rise in nine months.

## INDUSTRIAL PRODUCTION

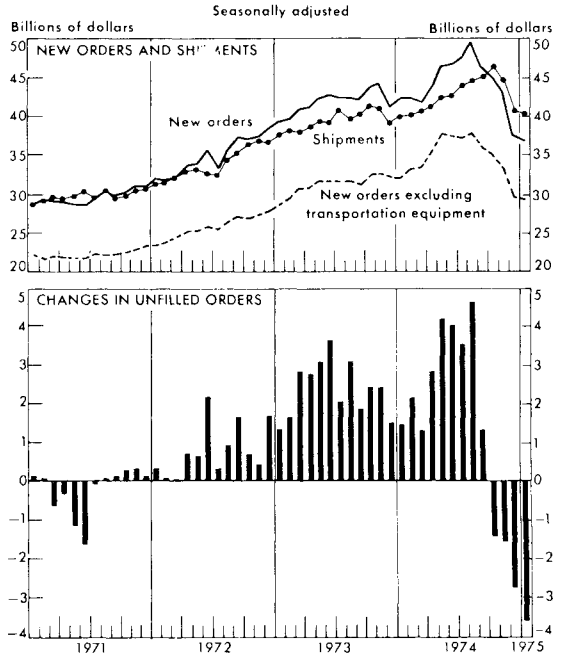
On a seasonally adjusted basis, industrial production declined 3.6 percent in January (see Chart I). Combined with the revised 3.1 percent drop recorded in December, this constitutes the sharpest two-month slide in industrial output since the 1930's. The January decrease, the fourth in as many months, left the Federal Reserve industrial production index at 113.7 (1967=100). This is 9.5 percent below its level at the end of September 1974 and 10.8 percent beneath its cyclical peak of November 1973.




*Revised estimates indicate that the gross national product (GNP) increased $13.9 billion on a seasonally adjusted annual-rate basis in the fourth quarter of 1974. However, while the estimate of real GNP remained unchanged from the preliminary figure, a decline of 9.1 percent, the annual rate of change of the implicit price deflator for GNP was raised from 13.7 percent to 14.4 percent.

The January cutback in industrial output was widespread, with sharp reductions in business equipment, consumer goods, and industrial materials. The output of business equipment fell 4.6 percent in January, after having declined 3 percent in December. The production of consumer durable goods was reduced by 6.1 percent, in part because of the 9.5 percent cutback in automobile output. Automobile assemblies in January proceeded at an annual rate of 4.8 million units, down from 8.3 million units in October when the auto manufacturers first announced their intentions to reduce the scale of operations. In February, automobile production declined even further to an annual rate of 4.4 million units. Facing a large overhang of inventories and weakening prices, producers of industrial materials reduced their rate of output in January by 4.1 percent. This followed the 4.6 percent contraction in December and brought the decline in industrial materials production to 13.8 percent since September. In mild contrast to the other manufacturing sectors, output in the mining and utilities industries increased slightly in January. The gain was attributable, however, to the large increase in coal production during the period following the settlement of the miners' strike in December.

Chart II
ORDERS AND SHIPMENTS OF MANUFACTURED DURABLE GOODS
Seasonally adjusted




Source: United States Department of Commerce, Bureau of the Census.

## CAPITAL APPROPRIATIONS, DURABLES ORDERS, AND INVENTORIES

Appropriations for new plant and equipment by the nation's 1,000 largest manufacturing firms declined by 24 percent in the fourth quarter of 1974, according to a survey by The Conference Board, Inc. Total appropriations in the fourth quarter were $12.5 billion, compared with $16.4 billion in the third quarter. The petroleum industry accounted for the largest changes in appropriations in both the third and fourth quarters of 1974. In the third quarter, firms in the petroleum industry increased appropriations by 18 percent, compared with only a 4.6 percent increase in the other industries. In the fourth quarter, however, firms in the petroleum industry reduced their appropriations by 57 percent, while nonpetroleum industries cut back only 7.4 percent.

New orders for durable manufactured goods declined $1.1 billion in January, continuing the downtrend that began last August (see Chart II). Most of the January drop is attributable to a $1 billion fall in the orders for primary metals. However, there were also sizable declines in orders for transportation equipment and machinery. Looking at marketing categories, bookings for household durables inched up in January, but the important capital goods group registered a $650 million decrease. The backlog of unfilled orders for durable goods also fell in January, by $3.6 billion. The latest decline, the fourth in a row, was the largest percentage contraction in durable goods orders backlogs since 1960.

Durable goods industries accounted for the entire increase in total manufacturing inventories during January. Inventories in the durable goods sector increased by $1.2 billion, while they declined by $0.1 billion in the nondurable goods industries. The breakdown of the January inventory advance by stage of fabrication implies that much of the gain was unintentional. Of the total $1.1 billion increase, more than half—$620 million—was composed of finished goods, while materials and supplies on hand rose $260 million and work in progress increased by $200 million.

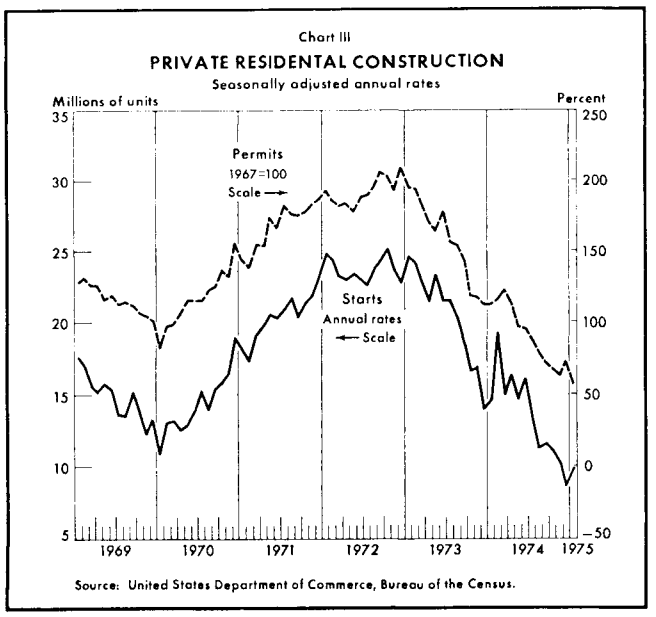
## PERSONAL INCOME, RETAIL SALES, AND RESIDENTIAL CONSTRUCTION

Personal income rose $2.6 billion in January, down from the $7 billion monthly rise averaged during 1974. The January gain occurred despite a $0.9 billion decline in wage and salary income; increases in dividends and interest and in transfer payments offset the fall in wages

and salaries. Reflecting the sharp cutbacks in employment and production, private industry payrolls decreased at a $1.8 billion annual rate in January. The reduction was concentrated in manufacturing, where payrolls have now fallen 6.4 percent since October and are only 0.6 percent above their level of January 1974. The weakness in manufacturing has been balanced somewhat by modest gains in wages and salaries in service industries and in government. In addition, transfer payments—social security, unemployment, and welfare and veterans' benefits—increased at a $2.7 billion rate in January, following a very large $6.3 billion increase in December. With the continued decline in farm prices, the income of farmers recorded its fourth consecutive monthly decrease in January. Over the year ended in January, farm income fell nearly 36 percent.

Spurred by unusually widespread clearance sales, retail sales increased 0.9 percent in January to a monthly total of $45.1 billion. This was the second successive increase in retail sales, following sizable declines in the three previous months. The dollar value of January's sales was 4.9 percent above that of a year earlier. However, since retail prices rose approximately 12 percent over this period, there has been a substantial reduction in the real volume of goods sold. Consumer spending on durable goods, which has been quite depressed in recent months by high interest rates and consumer pessimism, was 0.9 percent higher in January than in December. Most of the increase reflected the 2 percent increase in automobile sales that was motivated by the cash rebate programs initiated in the middle of the month. Sales of new domestic automobiles climbed to an annual rate of 6.6 million units in January and to 7.2 million units in February. Sales of nondurable goods were 1 percent higher in January than a month earlier and were 7.8 percent above their level of January 1974.

The residential construction industry showed tentative signs of recovery during January. Housing starts increased 13 percent to an annual rate of 987,000 units, up from December's 875,000 units (see Chart III). The prospects for further recovery remain clouded, however. The issuance of new building permits, which is sometimes an indicator of building activity in the following month or two, declined in January to the lowest point on record for the series, which dates to 1959. On the other hand, thrift institutions have realized substantial net deposit inflows during recent months. These inflows, combined with declines in short-term interest rates, should increase the supply of mortgage funds and eventually lead to lower financing costs. Another positive factor is the recent decline in the vacancy rate in multiple dwellings, which fell 0.2 percentage point during the fourth quarter of 1974 to 6 percent. The rental vacancy rate normally moves quite slowly, and a decline of this size indicates a firmer tone in the rental market which could stimulate new construction in the coming months.




## PRICE DEVELOPMENTS

In recent months, prices at the wholesale and retail levels provided further evidence that the rate of inflation is abating. Wholesale prices in February declined at a 9.2 percent annual rate, the third consecutive monthly decrease. While consumer prices in January increased at a 7.7 percent annual rate, this was the slowest advance since last April.

Contributing to the February decline in wholesale prices was the sharp 41.1 percent annual-rate drop in prices of farm products and processed foods and feeds. This weakness in farm product prices, following substantial declines in December and January, has led agricultural experts to speculate that supply conditions in these markets may have permanently improved and that food prices in the near future may be weaker than they were previously expected to be. The prices of industrial commodities at the wholesale level increased at a 6.5 percent annual rate in February. These prices over the past three months have risen at a 4.3 percent annual rate, which stands in sharp contrast to their performance during the preceding twelve

months when they rose 27.4 percent. The wholesale prices of basic raw materials fell at a 1.1 percent rate in February which, following their 19.4 percent rate of decline in January, suggests that final goods prices may soften in the months ahead as the recent decreases in materials prices work their way forward to advanced stages of production.

January marked the second consecutive month that the rate of inflation at the consumer level has slowed. Retail food prices increased at a 9.9 percent rate, slightly more rapid than December's advance. However, the acceleration is attributable to hikes in the prices of restaurant meals; grocery prices actually rose somewhat more slowly than they had in December. The prices of nonfood consumer items advanced at a 6.7 percent rate, as increases in the prices of shoes, gasoline, and household durables more than offset the decline in new car prices. In contrast, over the year ended November 1974, the prices of nonfood consumer items had risen 12.3 percent. The prices of services increased at a 9.6 percent rate in January, with household utility costs registering a substantial increase.

## LABOR MARKET DEVELOPMENTS

Labor market conditions deteriorated somewhat further in February, although the unemployment rate remained unchanged at 8.2 percent of the civilian labor force. Nonagricultural employment declined by over 450,000 persons, but this was more than matched by a fall in the labor force. The February decline in employment was the fifth in as many months, bringing the total decrease over the period since September 1974 to more than 2.2 million workers. Reflecting the reductions in industrial production, most of the drop in employment has occurred among adult males in manufacturing, while employment in the nonmanufacturing sector has fallen relatively little since September. The sharp decline in the labor force in February reversed the growth of recent months. Indeed, over the five months ended in February, the labor force decreased by nearly 340,000 workers. Taking a somewhat longer perspective, over the year ended in February the labor force climbed by 955,000, or 1.1 percent.

January's labor turnover rates also reveal the degree to which industry's demand for labor has eroded in recent months. The layoff rate jumped sharply to 3.5 percent, up from 2.6 percent in December. This increase brought the layoff rate in January to nearly three times what it was in September, when industrial production began to decline in earnest. Meanwhile, the scarcity of job openings caused the number of workers voluntarily leaving their jobs to decline to 1.4 percent. In September the quit rate was 2.1 percent, and in January 1974 it was 2.6 percent.

# The Business Situation

Economic activity continues to contract. While pervasive weakness in final demand has been a contributing factor, the dominant depressant in recent months has been the liquidation of inventories. Indeed, at the present time, the inventory correction appears to be the most important single factor restraining production and employment. In February, industrial production fell 3 percent, marking the fifth consecutive monthly decline. No doubt this protracted contraction in output has occurred in response to the sizable cutbacks in business capital spending and to the unusually steep decline in orders for other manufactured goods. Conditions in the labor market have lately evidenced a pronounced weakening, with the unemployment rate rising from 8.2 percent in February to 8.7 percent in March.

Despite the decidedly downward thrust of the economy, a few encouraging signs have appeared. Retail sales have staged an advance in recent months, even after allowing for concurrent price increases, and many retailers report improving inventory positions. Automobiles sales, boosted by the fall in effective prices, were comparatively brisk in February and have led to a noticeable reduction in the overhang of automotive inventories. The enlarged flow of funds into thrift institutions should eventually give rise to a recovery in residential housing construction, once the surplus of unsold new homes has been reduced a bit. These encouraging signs are quite tentative, however. While an economic upturn is in prospect, its timing and magnitude are still in question.

In coming months, further impetus to an economic recovery will derive from the tax-cut bill that was enacted by the Congress and signed into law by President Ford at the end of March. On balance, the new bill will amount to an estimated $22.8 billion reduction in personal and business taxes in 1975 and 1976. Included in the new legislation are several provisions that will benefit individuals. First, one provision calls for a 10 percent rebate on personal income taxes for 1974, totaling about $8.1 billion. While all taxpayers will benefit to some extent, those with adjusted gross incomes of $20,000 or less will receive greater tax relief. Second, in 1975, personal income tax liabilities will be reduced by about $7.8 billion. This reduction will be effected through a $30 tax credit for every taxpayer and his dependents and through increases in the standard deduction. Third, a tax credit for low-income families with children will reduce personal tax liabilities by about $1.5 billion in 1975. Fourth, at an estimated cost of $1.7 billion, all social security recipients, railroad retirement pensioners, and aged, blind, and disabled welfare recipients are scheduled to receive a $50 cash payment sometime in the summer. Fifth, unemployed workers will be able to draw unemployment compensation for an additional thirteen weeks, extending the period of eligibility to sixty-five weeks. Sixth, a 5 percent tax credit of up to $2,000 will apply toward the purchases of new houses that had been built or were under construction by March 25 and that are to be principal residences. Designed to stimulate residential construction, this measure will decrease personal income taxes in 1975 by about $0.6 billion.

Taken together, the other provisions in the new legislation will lower business taxes by about $3.1 billion. First, the investment tax credit for purchases of equipment is to be increased to 10 percent for two years, up from the 7 percent credit that had been in effect for most businesses and the 4 percent credit for utilities. Also, the amount of used equipment eligible for the credit was raised from $50,000 to $100,000, a change that will primarily benefit smaller businesses. These and other related provisions will reduce business tax liabilities by an estimated $3.4 billion. Second, the reduction in the tax rate applied to the first $50,000 of their profits will result in a $1.4 billion decrease in corporate tax liabilities. Partly offsetting these tax breaks, however, are two other measures that will increase the tax liabilities of some businesses. The oil depletion allowance was eliminated for the large oil companies and will be gradually phased out for

many smaller firms. And major changes were made in the tax treatment of multinational corporations. In the aggregate, the personal and corporate tax reductions provide a needed element of prompt economic stimulus. However, their implications for the long-term health of the economy are problematic. The tax bill substantially reduces the number of tax-paying citizens and decreases the Government's revenues from important sources. While these changes are presently considered temporary, they would constitute a marked erosion of the tax base with inflationary overtones should they become permanent fiscal arrangements.

On the price front, the outlook continues to be encouraging. Recent developments suggest that the combination of plummeting materials prices and slackening demand has begun to exert a dampening effect on finished goods prices. Consumer prices rose during February at a 7.7 percent annual rate, mainly because of a considerable softening in retail food prices. And wholesale prices in March declined for the fourth consecutive month. The prices of farm products and related items accounted for much of the weakness, although prices of industrial commodities increased at only a 2.2 percent annual rate.

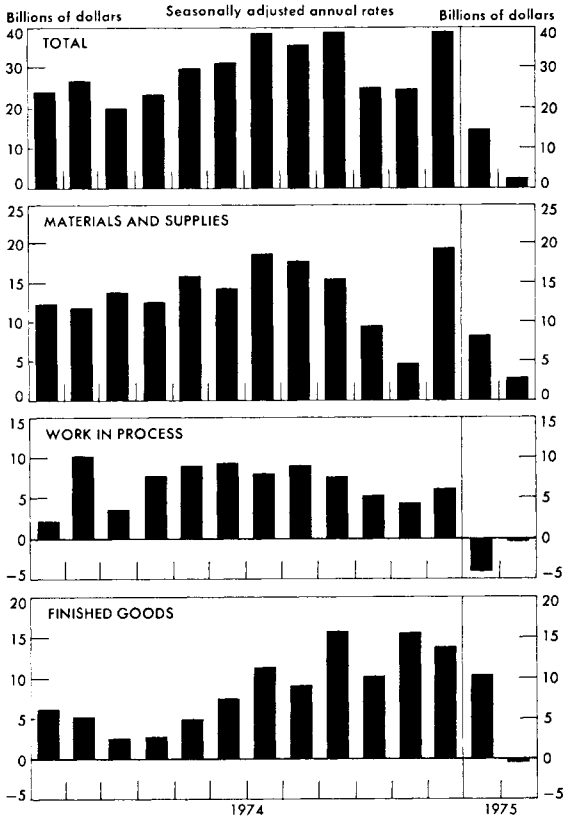
## INDUSTRIAL PRODUCTION, ORDERS, AND INVENTORIES

Industrial production fell 3 percent during February. This decline, the fifth in a row, brought the Federal Reserve's index of industrial production to 110.3, 12 percent below its September 1974 level. As in previous months, the February decline in manufacturing output was more noticeable in durable goods. Since September, the production of durable goods has fallen 15 percent, while nondurables are off about 11 percent. The production of automobiles and parts fell again in February but at a somewhat slower rate than in recent months. The February decline was 4.7 percent, compared with an average monthly reduction of 11.5 percent since October. The output of business equipment was reduced again in February and has fallen 9.8 percent since September. In addition to the cutbacks in durable goods production, the output of industrial materials was noticeably reduced both in February and during the preceding few months. The production of industrial materials fell 3.8 percent during February, bringing the total decline during the past five months to 17.9 percent.

New orders for durable goods increased by $900 million during February. This rise reversed a five-month trend during which durable goods orders declined by $13 billion, or 27 percent. A good portion of the February increase is attributable to a $479 million growth in the often volatile orders for defense equipment. However, orders for primary metals and household durables also showed significant advances. The 6.9 percent rise in orders for primary metals suggests that inventories of these metals are finally running down, which could stimulate an upturn in their production. The increase in orders for household durables was also the first in several months and, although it is but one indicator, it could reflect improvement in consumer confidence, which has deteriorated steadily over the past year. Another favorable sign in durable goods is that orders for nondefense capital goods were little changed in February. These orders had declined on balance over the previous five months, falling by 14.9 percent during the September-January period.

The book value of total business inventories declined in

Chart I
CHANGES IN MANUFACTURERS' INVENTORIES BY STAGE OF FABRICATION




Source: United States Department of Commerce, Bureau of the Census.

January for the first time in over four years. The January decrease was $148 million, compared with a seasonally adjusted $3.9 billion increase in December and a $45 billion gain over the previous twelve months. The January decline in all business inventories was caused by substantial reductions in the wholesale and retail trade sectors. Apparently, the pattern in recent months of declining orders to manufacturers against relatively stable wholesale and retail sales has resulted in a running-down of inventories at the wholesale and retail levels. Should this pattern continue, one would expect a restoration of orders to manufacturers in the near future and eventually a higher rate of industrial production.

Approximately one half of the January decline in retail inventories is attributable to automobiles. Automobile dealers' inventories fell even further in February, and at the month end their inventories amounted to sixty days of sales. This is the lowest inventory-sales ratio since September and is substantially below the November level, when dealers held inventories equal to 101 days of sales. Of course, the February figure was lowered by the price rebate program which stimulated sales.

Manufacturers' inventories increased in February but by only 0.1 percent, their smallest gain in three and one-half years. Stocks of finished goods actually declined by $30 million, and work in progress fell by $30 million as well (see Chart I). The entire inventory increase was in materials and supplies, which rose by $245 million. Presumably, the failure of materials stores to decline is partly explained by the fact that some manufacturers are taking advantage of increasingly attractive materials prices.


## PERSONAL INCOME, CONSUMER DEMAND, AND RESIDENTIAL CONSTRUCTION

Personal income increased in February by a seasonally adjusted $2.9 billion to an annual rate of $1,194 billion. The February increase was somewhat larger than the gain recorded in January; however, it was quite small compared with the average monthly gain for 1974. Reflecting recent declines in production, payrolls in manufacturing and other commodity-producing sectors dropped at a seasonally adjusted annual rate of $5.7 billion. Income in the service and distribution industries increased at a $2.5 billion rate, however, and limited the decline in total private payrolls to $3.2 billion. Unemployment benefits, which have climbed quickly with the unemployment rate in recent months, increased by $2.7 billion in February. This jump, along with a rise in social security, unemployment, and veterans' benefits, brought the increase of total transfer payments to an annual rate of $6.7 billion. Farm income moved lower in February for the fifth consecutive month, falling 12 percent to a $23 billion annual rate. Over the twelve-month period ended in February, farm income has fallen by 41 percent.

Consumer spending at retail stores registered a marginal increase of $210 million during February. This was the third consecutive month in which retail sales have risen (see Chart II). However, the gains have been quite small, and sales have yet to regain their level of last September. Of the February increase, approximately two thirds was in the durable goods category and was accounted for by automobile sales. During that month, passenger car sales, reflecting the effects of the price rebates offered by most manufacturers, proceeded at an annual rate of 7.2 million units, compared with an average of 6.2 million units during the previous four months. In March, after many of the special sales programs ended, automobile sales declined sharply to a 6 million unit annual rate, the slowest sales pace since November.

The housing picture is still decidedly weak. Housing starts fell by 2 percent in February to an annual rate of 977,000 units from January's 996,000. This pace of starts was somewhat higher than December's low of 880,000 starts, but it was 48 percent below the level of last February. Permits to build new housing units were down

in February to a record-low annual rate of 673,000 units. Permits to construct multifamily dwellings fell to 106,000, 80 percent below the level of last February. Meanwhile, permits for single-family residences increased for the second consecutive month to an annual rate of 514,000.

Sales of new single-family houses increased by 2 percent in January to 395,000, compared with December's 387,000 sales. By the end of January, the combination of low housing starts and somewhat faster housing sales had reduced the inventory of unsold single-family houses to approximately 400,000 units, nearly 50,000 houses fewer than the inventory of a year ago but, because of the recent slow pace of sales, the ratio of inventory to sales in January was somewhat higher than it had been a year earlier.

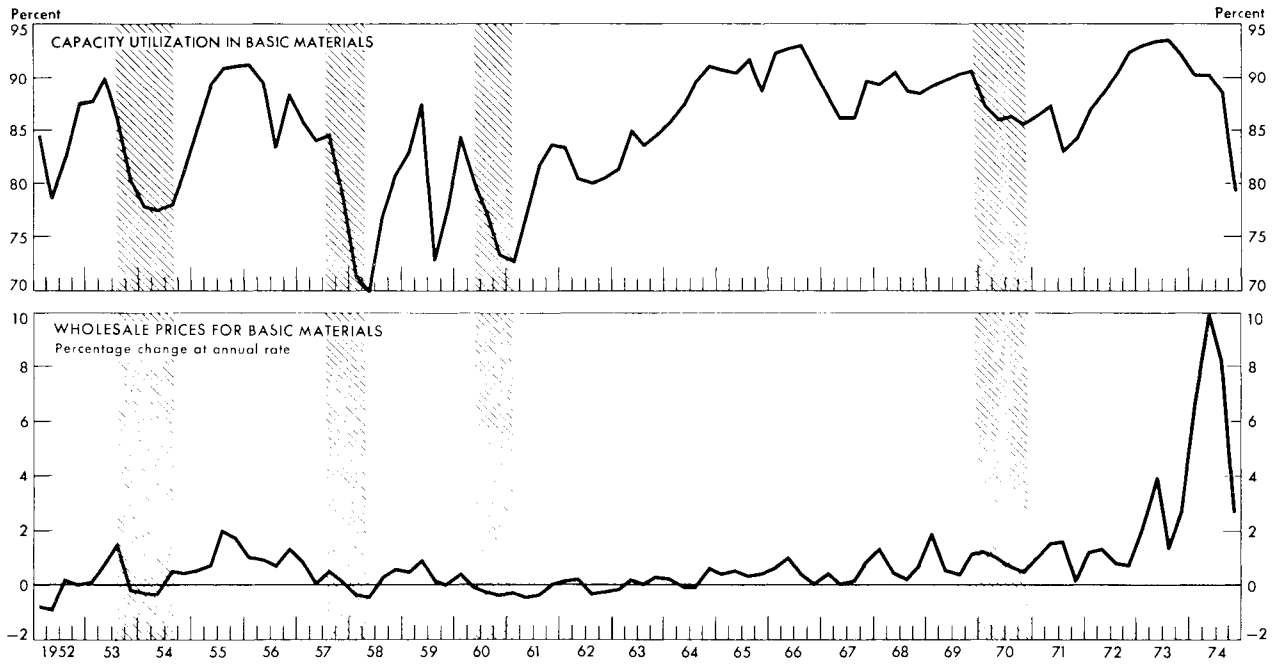
## SUPPLY OF BASIC MATERIALS

Against the backdrop of a weakened economy and excessive inventory accumulation, substantial amounts of excess capacity have developed. The existence of unused capacity has been influential during business cycles in the past, and it will doubtless condition the real output and price performance of the economy in the near future. Nowhere has unused capacity been more evident than in the basic materials industries where utilization rates fell from an average 93 percent in 1973 to 79.3 percent in the fourth quarter of 1974, the lowest level in more than thirteen years. With the exception of the paper industry, which has continued to operate at nearly full capacity, this decline has been broadly based as well. To cite a few examples, utilization in the chemicals industry dropped from 90 percent in the fourth quarter of 1973 to 72 percent one year later, and metal producers were operating at 84.5 percent of capacity in the October-December 1974 period, down 8.7 percentage points from the peak reached in the final three months of 1973.

Judging from previous years, however, the capacity constraints and materials shortages which characterized 1973 were unusually severe. Materials producers' capacity utilization rates rose above 90 percent during each of the four

Chart III

CAPACITY UTILIZATION AND WHOLESALE PRICES OF BASIC MATERIALS INDUSTRIES




Note: Shaded areas represent recession periods, indicated by the National Bureau of Economic Research chronology.
Sources: United States Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System.

post-World War II economic booms, and forward commitments of purchasing agents lengthened considerably. But, while a maximum of only 50 percent of purchasing agents believed it necessary to order materials more than ninety days in advance during each of the three earlier booms, 65 percent believed such a lead time necessary in 1973. In retrospect, the unusually tight bottlenecks that occurred at the end of 1973 are probably attributable to the effects of the Economic Stabilization Program and the devaluation of the United States dollar.

In any event, supply constraints similar to those that developed in 1973 are not likely to reappear in the near future. As indicated in Chart III, while changes in the utilization rate for materials producers tend to mirror swings in overall economic activity, slack has often persisted beyond the onset of recoveries. Moreover, since materials prices are extremely sensitive to prevailing supply conditions, inflationary pressures have eased for several quarters beyond the business-cycle troughs as well. After falling rather sharply during the contractions in 1953-54 and 1957-58, for example, capacity utilization picked up, but it did not return to its earlier cyclical peak until four quarters after the economy started to rebound. Although materials prices immediately began rising in response to the improvement in economic activity in the third quarter of 1954 and in the second quarter of 1958, these increases were smaller than they had been during each of the previous expansions. In 1961 the decline in utilization was not nearly so dramatic, since a large amount of surplus capacity already existed and only two quarters passed before the earlier peak was attained. Despite this, materials prices remained quite stable, failing to rise significantly until the end of 1964. More recently, the mild decline in utilization which occurred in 1970 required two full years before capacity utilization approached the peak established in the fourth quarter of 1969 and materials prices began to accelerate.

Cyclical declines in plant utilization have tended to stretch beyond general economic contractions partly because of the bursts in capital investment that typically have occurred during the prior expansion. As measured by the Commerce Department, over the year preceding each of the four postwar cyclical peaks, capital spending by major materials producers rose an average $1.1 billion above year-earlier levels. However, since fairly long periods must expire before new plant and equipment emerge from these expenditures, additions to capacity have rarely surfaced until recoveries were under way. In this respect, a very similar pattern seems to be unfolding for 1975. Capital spending in 1973 rose $3.1 billion above the 1972 level and, while a portion of the increase was caused by inflation, even in real terms there was a substantial jump. As a result, a sufficient amount of new capacity should emerge during 1975 so that the current slack in utilization may persist for a time, thus helping to temper a rekindling of inflationary pressures.

## PRICE DEVELOPMENTS

Consumer prices increased at a seasonally adjusted annual rate of 7.7 percent during February. This was the second consecutive month in which the consumer price index rose at this rate, providing additional evidence that inflation has fallen back from the rates in excess of 10 percent that were experienced during 1974. The February increase brought the annual rate of consumer price rise for the three-month period since November to 7.8 percent, compared with 12.4 percent for the previous three-month interval. During the twelve months ended in February, consumer prices advanced 11.1 percent.

Retail food prices increased at only a 0.7 percent annual rate during February, their slowest rise since last July. This break in the rate of food inflation reflects, among other factors, a working-forward of the lower wholesale food prices that have been observed during recent months. For example, for the three-month period ended in February, wholesale prices of farm products and processed foods and feeds fell at nearly a 33 percent annual rate.

Excluding foods, the consumer price index advanced at a 10.3 percent annual rate in February, compared with 7.9 percent in January. The prices of nonfood commodities increased at a 10 percent rate, while service prices rose at a 9.7 percent pace. Among the commodity group, price rises were most pronounced among durable goods, which rose at a 12 percent annual rate. Looking at energy prices, consumer fees for gas and electricity increased at a 17.3 percent annual rate, while the prices of fuel oil and coal declined at a 0.5 percent pace.

Wholesale prices fell at a seasonally adjusted annual rate of 7.4 percent in March, sustaining a decline that set in last December. As in previous months, the reduction was due entirely to lower agricultural prices. Wholesale farm and feed prices dropped at a 30.4 percent annual rate in March, bringing the decline over the last three months to 33.1 percent. Moreover, with spot prices of foodstuffs moving down in recent weeks, the prospect of additional declines at the wholesale level appear likely. At the same time, wholesale prices of industrial commodities slowed to a 2.2 percent annual-rate gain in March. Over the past six months, industrial commodities prices have increased at a 6.5 percent annual rate, well below the 31.5 percent advance posted over the first half of 1974.

## LABOR MARKET DEVELOPMENTS

Unemployment in March rose to 8.7 percent of the civilian labor force, after having held steady at 8.2 percent the preceding month. The number of unemployed persons increased by almost 500,000 to nearly 8 million, the largest number of workers without jobs since 1940. The latest rise in unemployment was caused both by a sizable number of entrants into the labor force and by a reduction in employment. During March, the civilian labor force expanded by 320,000 persons to 91.8 million, while the number of persons employed dropped by 180,000 to 83.9 million workers. All of the major categories of workers experienced higher unemployment in March; however, reflecting the continuing fall in industrial production, blue collar workers were especially hard hit. The unemployment rate among blue collar workers rose to 12.5 percent, compared with 10.9 percent in February.

Average hourly earnings increased in March at their fastest rate in nine months. The March gain was at a 12.9 percent annual rate, compared with increases of 6.5 percent in January and February. Earnings moved higher in all major industries. The gains were especially large in construction, where earnings rose at more than a 30 percent annual rate, after having declined at about a 13 percent rate during February. Reflecting the low level of construction activity over the past year, earnings in construction have risen more slowly than in other industries. For example, since March 1974, average hourly earnings in construction increased 8.5 percent, compared with an 11.4 percent rise in manufacturing and a 13.7 percent advance in mining wages.

# The Business Situation

Economic activity has continued to decline, extending the duration of this most severe of the postwar recessions. In recent months the contraction has been primarily the result of a massive turnaround from inventory building to inventory liquidation, as firms have attempted to bring stocks into line with sales. The inventory correction currently under way is an essential element in setting the stage for future recovery. While the timing of the recession's end remains uncertain, a few encouraging signs have begun to appear in the economy. Consumption spending in recent months has shown tentative signs of renewed strength. While post-rebate car sales have been disappointing, the freewheeling fall in automotive sales appears to have bottomed out. Moreover, consumers have actually stepped up their purchases of other goods and services. No doubt further impetus to consumption spending will come from the recently passed tax reductions, which will add about $20 billion to disposable income. In addition, the substantial recovery in the stock market, amounting to more than 40 percent since early December, will probably also contribute to some pickup in consumer spending.

In the first quarter, real gross national product (GNP) dropped at a 10.4 percent annual rate, the steepest quarterly decline on record, to a level 7.5 percent below the peak attained at the end of 1973. While reductions in business fixed investment and residential construction contributed to the first-quarter fall, substantial inventory disinvestment was the major factor. Although inventory liquidation will probably persist for some time, it is unlikely to exert such a large drag on overall activity again. Conditions in the labor market deteriorated somewhat further in April as the unemployment rate rose from 8.7 percent to 8.9 percent. However, total employment increased for the first time in seven months.

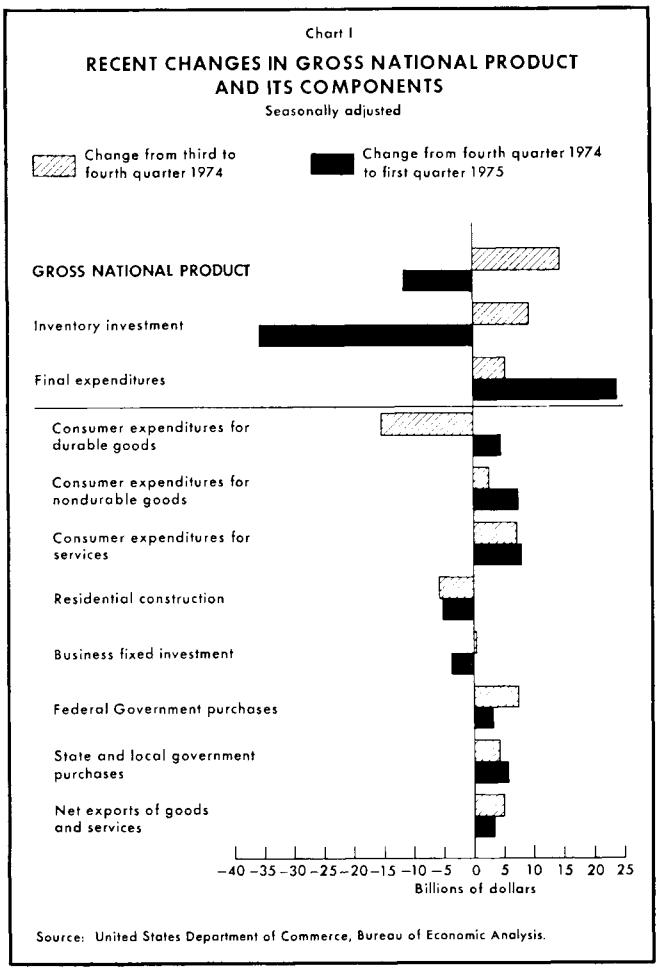
In recent months, there has been noticeable improvement in the price situation. The implicit price deflator for GNP rose at an 8 percent annual rate in the first quarter, the slowest advance since the second quarter of 1973. Much of this deceleration reflected the sharp plunge in farm prices. The implicit price deflator for the private nonfarm business sector increased at an 11.8 percent annual rate in the first three months of the year, down only modestly from the 13.2 percent rate of inflation recorded in the last quarter of 1974. Wholesale prices of industrial commodities have lately shown significant improvement, however. During the first quarter, these prices increased at a 5 percent annual rate, on average, well below the 7.9 percent advance of the previous quarter. In contrast, the slowdown in the rise of retail prices was much less pronounced. In all likelihood, however, the full impact of the moderation in nonfood wholesale prices has not yet been registered at the consumer level.

## GROSS NATIONAL PRODUCT AND RELATED DEVELOPMENTS

According to preliminary data released by the Department of Commerce, the market value of the nation's output of goods and services declined by $11.7 billion during the first quarter to a seasonally adjusted annual rate of $1,419.2 billion. This amounted to a 3.2 percent annual-rate decline and was the first drop in nominal GNP in over fourteen years. Moreover, after correcting for changes in the price level, real GNP fell at a 10.4 percent annual rate, the fifth consecutive quarterly decline in real output and the sharpest quarterly reduction on record. (Quarterly GNP data extend back to 1946.) Thus far, real output has fallen 7.5 percent below the peak attained at the end of 1973.

The sizable liquidation of inventories was the most important factor affecting GNP in the first quarter (see Chart I). According to preliminary estimates based on partial data, total business inventories were pared at an $18 billion annual rate, creating a huge $35.8 billion swing from the rate of investment in the previous quarter. In contrast, current-dollar final expenditures—GNP excluding inventory investment—actually rose by $24 billion in the first quarter, compared with an increase of only $5.5 billion in the fourth quarter of 1974.

The liquidation of excess stocks was spread across all




the major sectors. Stocks of durable and nondurable manufactured goods were reduced $11.2 billion and $6.8 billion, respectively, while farm inventories fell $1.6 billion at an annual rate. All the rundown in durables stocks occurred in the automotive sector. Last November, faced with a sales slump and a record 102 days' supply of automobiles, domestic manufacturers drastically cut production. However, little dent was made in the overhang of unsold automobiles until the price rebates on new cars were instituted in January. Sales then perked up in response to the lower effective prices, and car inventories were gradually drawn down, easing to 68 days of sales by the end of March. Despite this correction, the stock of nonfarm inventories, including unsold automobiles, still appears to be on the high side, and some further paring will undoubtedly take place in coming months. In the first quarter, based on GNP data, the real inventory-sales ratio for the nonfarm sector climbed to the highest level since 1952 (see Chart II). Moreover, according to the March survey of the National Association of Purchasing Management, about 50 percent of the respondents reported that they expected to continue working off excess stocks in coming months. While this suggests that further inventory liquidation is in prospect, there is a basis for believing that the worst has passed and that inventory investment will be a less severe drag on the economy in the months ahead. Indeed, disinvestment in the first quarter was so large that inventories would have to be reduced at three times the $18 billion annual rate of the first quarter to exert an equal drag on GNP.

Personal consumption spending exhibited renewed growth in the first quarter, rising by $20.5 billion. While in real terms the increase amounted to a modest $4.1 billion, this was still a vast improvement over the huge $19 billion plunge that occurred in the previous quarter. To a large extent, this pattern reflected the movements in consumers' purchases of durable goods, particularly automotive goods. However, even excluding autos, consumer durables spending managed to post a modest advance in the first quarter. The anticipation of the income tax rebates, as well as the publicity given to widespread price rebate programs, was probably influential in boosting consumption. Moreover, these factors may also have contributed to some recent improvement in consumer attitudes. For instance, The Conference Board survey conducted during January and February pointed to a rise in consumer sentiment of 11 percentage points. In coming months, consumption spending should receive additional impetus from the recently passed tax reductions. In all, about $20 billion will be added to disposable income in 1975, of which $8 billion will be derived from the income tax rebates. While consumers initially may choose to save this increment or use it to repay debt, it may eventually be used to purchase goods and services that they might not otherwise have purchased. Consumption spending will no doubt be a key element determining both the timing and vigor of the prospective economic recovery.

Residential construction spending declined by $5.2 billion in the first quarter, leaving expenditures on new housing about 40 percent below the peak reached in the second quarter of 1973. Much of the decline, however, is attributable to the sharp slide in housing starts that occurred throughout the second half of 1974. New housing starts leveled off during the first quarter at an average annual rate of 988,000 units. This is well above the depressed December figure of 880,000 units and suggests that the bottom of the current housing slide may have been reached. With a sizable volume of funds flowing

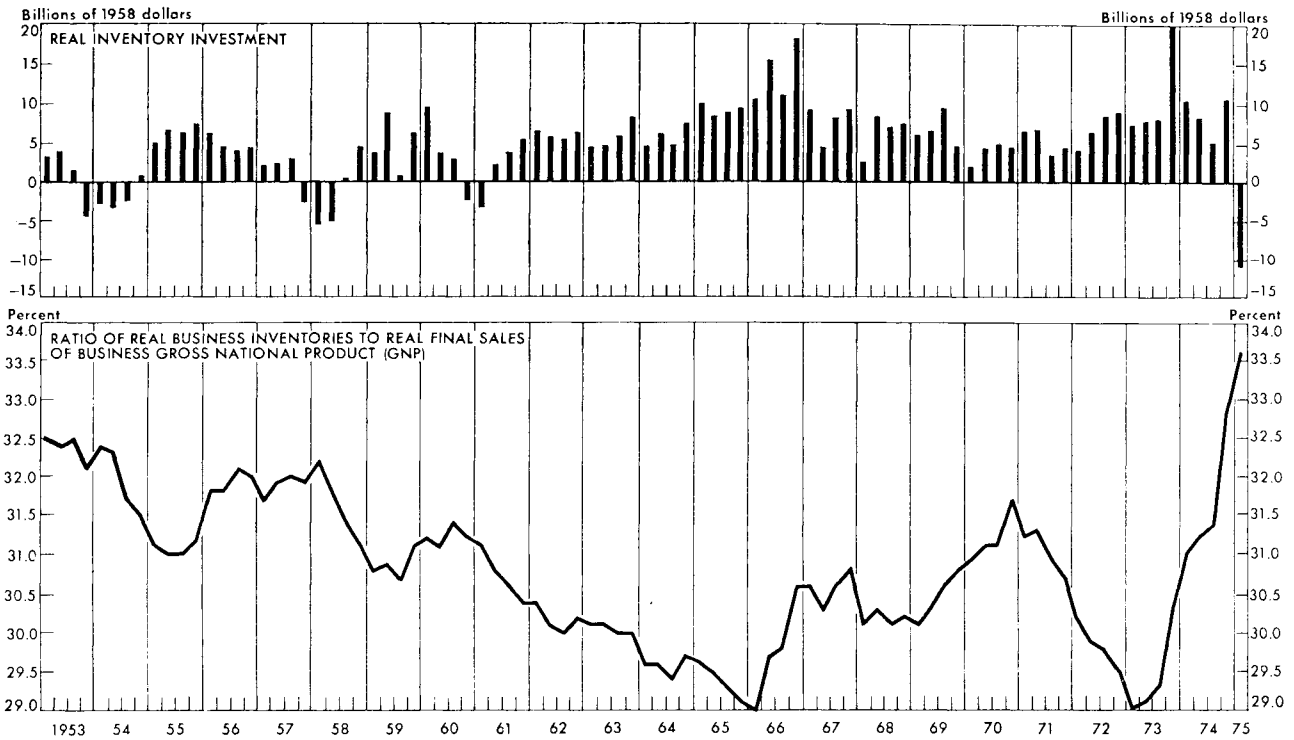
into thrift institutions, housing should receive some stimulus in coming months. In the first quarter the nation's thrift institutions are estimated to have gained deposits at a rate more than double that averaged over the last half of 1974. Despite these inflows, an outright advance in new home construction has not yet developed. Before the long-awaited recovery can begin, thrift institutions will have to rebuild their liquidity positions and the large backlog of unsold new homes will have to be reduced. Building permits continued to fall during the January-March period, declining to the lowest level on record.

Business fixed investment fell by $3.8 billion in the January-March period, the first outright decline since a strike in the automobile industry depressed business investment in the last quarter of 1970. In real terms, the drop was even greater, as constant-dollar expenditures on structures fell by $0.8 billion, while spending on equipment declined by $4.3 billion. Businesses have apparently reduced their capital spending plans as well. According to the most recent Commerce Department survey, taken during January and February, spending on new plant and equipment is expected to rise 3.3 percent in 1975. Not only is this less than the 4.6 percent rise projected in the preceding Commerce survey but, after allowing for expected increases in capital goods prices, it also represents an 8.5 percent decline in real business outlays. The latest McGraw-Hill survey also projects that real capital spending will fall in 1975 but only by 5 percent. In current dollars, business spending reportedly will rise by 5 percent over the 1974 level with more than half the total amount allocated toward modernization and replacement of plant and equipment rather than expansion. This reluctance to add to capacity is not surprising since a great deal of idle capacity currently exists. In the first quarter, manufacturers were producing at only 68.3 per-

Chart II

REAL INVENTORY INVESTMENT AND REAL INVENTORY-SALES RATIOS IN THE GNP ACCOUNTS

Seasonally adjusted annual rates

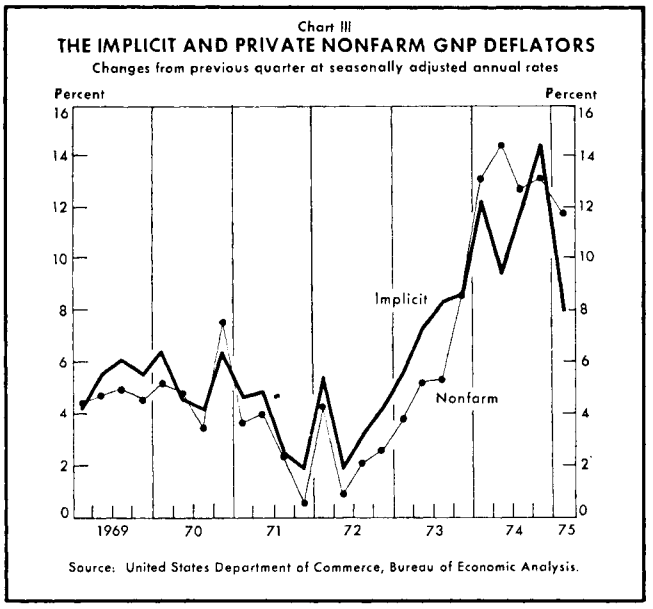



Source: United States Department of Commerce.

cent of capacity and, in the sensitive major materials industries, plant utilization fell to 70.7 percent, the lowest level since the second quarter of 1958. In any event, the rise in the investment tax credit included in the tax-cut legislation might provide some stimulus to investment later in the year.

Government purchases of goods and services rose by $9 billion in the first quarter, compared with $11.5 billion in the previous quarter. Federal outlays advanced by $3.2 billion, or less than half the increase posted in the fourth quarter, while state and local outlays rose by $5.8 billion. In real terms, outlays at each level advanced by $1 billion.

Finally, net exports rose by $3.5 billion in the January-March period despite the fact that both exports and imports declined. A $4 billion reduction in exports was due entirely to a drop in exports of services. Agricultural exports increased sharply during the first quarter, while exports of other goods remained strong. Meanwhile, imports fell by $7.6 billion, the second consecutive quarter in which imports have declined. With the exception of capital goods, imports of all goods and services were weaker. Petroleum imports, which fell by 12 percent during the January-March period, registered the sharpest drop. If anything, the overall improvement in net exports suggests that the recession has been more severe in the United States than it has been abroad.




## PRICE DEVELOPMENTS

Inflationary pressure showed further signs of easing in the first quarter. As measured by the implicit GNP deflator, prices of goods and services rose at an 8 percent seasonally adjusted annual rate. Although this remains intolerably high, it was sharply below the 14.4 percent advance of the previous quarter and was the slowest rate of advance since the second quarter of 1973. However, this improvement was distorted somewhat by the dramatic fall in farm prices. Thus, the implicit price deflator for the private nonfarm economy rose at an 11.8 percent annual rate in the January-March period, a mild improvement over the 13.2 percent increase recorded in the final quarter of 1974 (see Chart III). The fixed-weight GNP price index, which is unaffected by changes in the composition of output, rose at a 7.1 percent seasonally adjusted annual rate, compared with a 12.4 percent gain in the previous quarter.

Consumer prices rose at a 6.4 percent seasonally adjusted annual rate in the first quarter, down substantially from the 9.8 percent advance recorded in the previous quarter. The slowdown was mainly attributable to a mild 3.7 percent annual-rate rise in consumer prices during March, the smallest monthly advance since July 1973 when a partial price freeze was in effect. Responding to earlier declines at the wholesale level, retail food prices fell at a 6.3 percent annual rate in March. In addition, nonfood commodity prices rose at a 7.4 percent annual rate during the month, well below the 11.3 percent advance recorded in the last half of 1974. Finally, prices of consumer services increased at a 4.4 percent annual rate in March, compared with the 9.4 percent advance posted over the last six months. The moderation was due largely to a decline in mortgage interest rates.

Wholesale prices fell at a 6.8 percent seasonally adjusted annual rate in the first quarter, in sharp contrast to the 12.7 percent advance posted in the previous quarter. While the decline was centered in agricultural prices, which fell at a 33 percent annual rate during the January-March period, there was also a noticeable moderation in price increases for industrial commodities. During the first quarter, wholesale industrial prices rose at a 5 percent annual rate, well below the 7.9 percent advance that occurred in the fourth quarter of 1974. With prices of crude materials excluding food and feed declining at a 7.7 percent annual rate in the first quarter, further moderation in industrial prices appears likely. Moreover, the fact that wholesale prices of consumer finished goods rose at only a 4.9 percent annual rate in the first quarter suggests that there will be further relief at the retail level as well.

## PRODUCTIVITY, WAGES, AND EMPLOYMENT

Despite the economic slump, cost pressures apparently mounted during the first quarter, as compensation per hour worked in the private economy rose at a 10.4 percent seasonally adjusted annual rate. This sizable increase, when adjusted for the slowdown in consumer prices, enabled real hourly compensation to rise modestly after two consecutive quarterly declines. Output per hour worked, which typically begins rising during the latter stages of economic contractions, edged up at a 0.6 percent annual rate in the January-March period. However, this was due to a sharp increase in farm productivity, which more than offset a further decline in productivity in the nonfarm sector. As a consequence of these changes in compensation and output per hour worked, unit labor costs rose at a 9.7 percent annual rate in the first quarter.

According to a separate survey of collective bargaining agreements covering 5,000 or more workers, agreements reached in the first quarter provided for a 13 percent annual rise in wages and benefits in the first year of the contract and a 7.5 percent gain over the life of the contract. Evidently, unions are still striving to make up for previous losses in real earnings as a result of inflation. For wages alone, first-year increases amounted to 12.5 percent while life-of-contract settlements provided for a 7.7 percent annual increase. The most lucrative settlements were negotiated in nonmanufacturing, but contract settlements in manufacturing, where unemployment has been especially severe, also were quite liberal. Settlements in the construction industry were modest, partly because of the small number of contracts that were signed during the period. Effective wages—which include gains arising from current settlements, deferred increases negotiated in earlier years, and additional gains resulting from escalator clauses—increased at a 6.1 percent annual rate during the first quarter, after rising 9.4 percent in all of 1974. Only 2 percent of the first quarter's advance was attributable to current decisions as opposed to 4.8 percent in 1974. Previous settlements accounted for another 2.4 percent, while only 1.6 percent resulted from escalator provisions.

Labor market conditions deteriorated somewhat further in April, although there was a gain in total employment. According to the household survey, the civilian labor force rose sharply by 433,000 persons in April after growing very little over the previous six months. Apparently, many workers had either dropped out of the labor force or delayed their entry because of the dismal job situation. Meanwhile, the number of persons employed rose by 237,000 in April, the first such increase since last September. This rise was less than the growth in the labor force, however, so that the seasonally adjusted unemployment rate rose by 0.2 percentage point to 8.9 percent in April. All labor force groups shared in this rise in joblessness. At 5.6 percent, the jobless rate for married men was the highest since August 1958. The nonwhite unemployment rate climbed to 14.6 percent in April, while the white jobless rate rose 0.1 percentage point to 8.1 percent.

According to the payroll survey of establishments, seasonally adjusted nonfarm payroll employment dropped slightly in April. Of course, the household and payroll surveys often diverge in a particular month because of sampling and coverage differences; however, over longer periods they tend to show comparable changes. Manufacturing employment fell by 96,000 workers in April, but the decline was much smaller than it had been in previous months. The stepped-up pace of automobile production in April led to some reduction in layoffs in this industry. Employment fell slightly in the construction and public utilities industries in April, while jobs in government, trade, and services increased.

# The Business Situation

While the latest readings of business statistics point to further slippage in economic activity, they also suggest that the low point of the recession may be reasonably near at hand.* Industrial production declined again in April, but the drop was the smallest since August 1974. No doubt this cutback in production reflects the ongoing inventory correction. The book value of manufacturers' inventories fell in April for the second consecutive month, with the decrease probably fairly substantial in physical terms. Although inventories still appear to be high in relation to sales, and it is thus difficult to determine how much further inventory liquidation will be carried, the recent rate of liquidation seems unlikely to be intensified further.

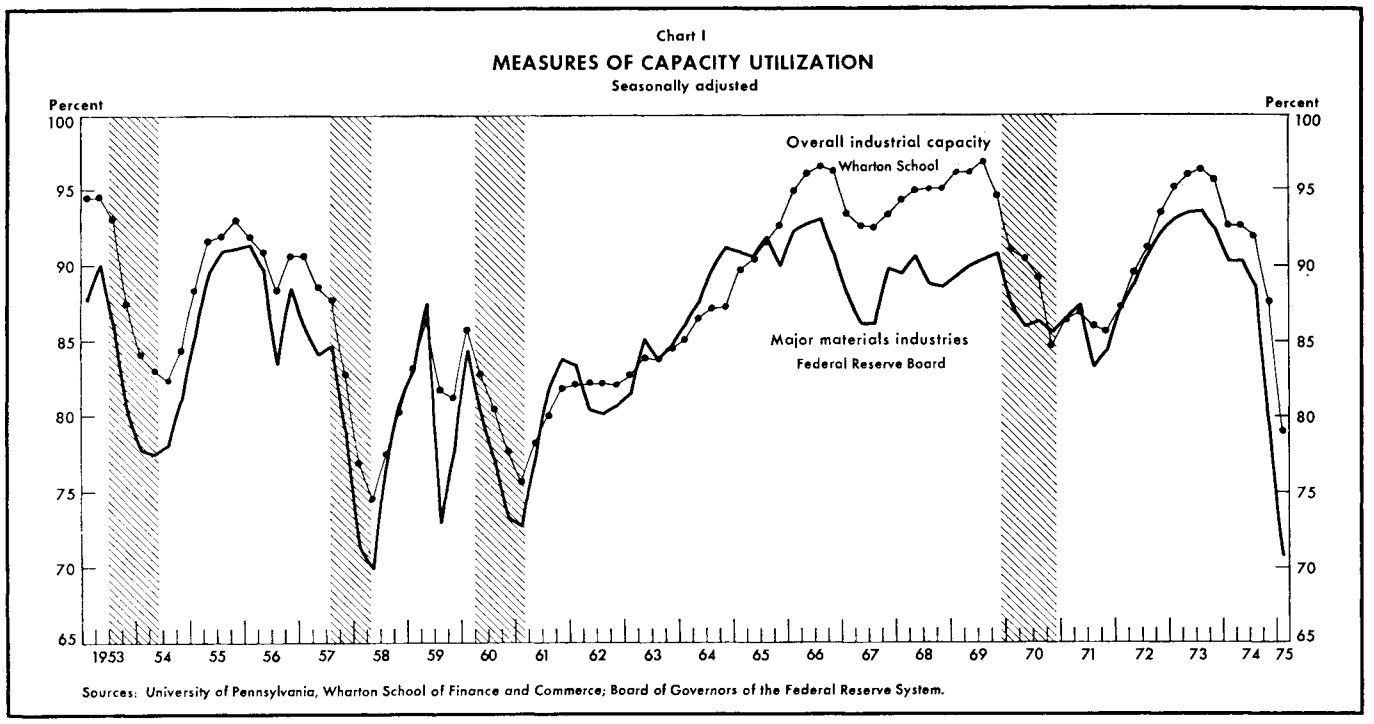
Meanwhile, other signs of a possible improvement in the economic weather have begun to accumulate. Manufactured durable goods orders rose in April for the second time in three months. This increase was the largest in more than seven years and was broadly based as well. Personal income also advanced in April, and retail sales increased despite a relapse in auto sales. Looking ahead, as the tax cut takes effect and rebate checks are distributed, sales should receive additional stimulus. While residential construction has not yet pulled out of its slump, housing starts did manage a mild increase in April and building permits climbed to the highest level since last August. Labor market conditions weakened further in May, as a sharp rise in the civilian labor force helped push the unemployment rate up to 9.2 percent. Nevertheless, total employment did manage to increase for the second consecutive month.

*Revised estimates indicate that current-dollar gross national product (GNP) fell $13.8 billion, instead of $11.7 billion, at a seasonally adjusted annual rate in the first quarter of 1975. Inventory liquidation was revised from $18 billion to $19.2 billion, and consumer spending was less robust than initially estimated, rising $17.4 billion instead of $20.5 billion. In real terms, GNP declined 11.3 percent instead of 10.4 percent as initially reported, while the annual rate of change in the implicit price deflator for GNP was revised slightly from 8 percent to 8.5 percent.

The price news was mixed in April and May, but on balance the recent pattern of more moderate overall inflation continues to prevail. Consumer prices rose faster in April than in the two previous months, as food prices increased after two months of decline. While the advance of nonfood commodity prices also accelerated somewhat in April, the overall increase in these retail prices in the February-April period was slower than in any other three-month interval in more than two years. At the wholesale level, prices rose for the second consecutive month in May, as prices for farm products and related items moved higher. On the other hand, increases in industrial commodity prices continued to be encouragingly mild. In May, wholesale industrial prices edged up at a 2.1 percent annual rate. Increases in prices of fuel and power accounted for most of this rise, so that if energy is excluded industrial wholesale prices barely changed.

## INDUSTRIAL PRODUCTION AND CAPACITY

As measured by the Board of Governors of the Federal Reserve System, industrial production fell 0.4 percent in April, thereby dropping 14.2 percent below its peak of November 1973. The most recent decline in this measure of the nation's output of factories, mines, and utilities was the smallest since last August. As in previous months, the production of business equipment and industrial materials posted sizable reductions. However, the output of consumer goods rose modestly in April, the first such increase since last June. Although the production of nondurable consumer goods rose somewhat, the overall increase chiefly reflected a rise in the output of durable consumer goods, especially automobiles. Encouraged by the success of the price-rebate program and anticipating the traditional spring upturn in automotive sales, manufacturers in April boosted production 26 percent above the average first-quarter rate. In May, automotive production rose even higher. Unfortunately, however, domestic auto sales have been sluggish in recent months, and the increased production has been added to the stock of unsold cars.




Quite unlike the situation that prevailed at the end of 1973, the economy is now operating well below its productive potential. Indeed, some observers have suggested that there is now more slack and unused resources in the economy than at any time since the end of the Great Depression. This seems to be an overstatement, however. Rather, the evidence would appear to justify the view that the current level of excess capacity is more like that experienced during the 1957-58 and 1960-61 recessions than that experienced just prior to World War II.

The Federal Reserve Board compiles two indexes which measure the utilization of the physical stock of plant and equipment in the manufacturing sector and in the major materials industries, respectively. While the index for manufacturing reached its lowest level in twenty-two years in the first quarter, there is reason to believe that this measure has tended to overstate capacity in recent years and hence this reading should be discounted to some degree. The major materials capacity utilization series appears to be a more accurate measure. Unlike the index for total manufacturing, utilization rates among the twelve major materials producers are based on estimates of maximum output. Although its coverage is limited, this indicator does succeed in measuring the extent of aggregate demand pressures at the initial stage of the production process. Indeed, output in the primary processing industries was severely strained during the 1973 boom, causing serious bottleneck problems throughout the entire economy. The major materials utilization rate reflected these pressures, as it climbed to a peak of 93.5 percent in the third quarter of 1973 (see Chart I), with some basic industries producing at nearly 100 percent of capacity. Since then, of course, the utilization rate has fallen. In the first quarter of 1975, the extent of used plant and equipment in this subsector equaled 70.7 percent. At this level, the index stood midway between the lows attained in the 1957-58 and 1960-61 recessions.

In addition, there is the Wharton School comprehensive index of capacity utilization which reached an exceptionally high rate of capacity utilization in the third quarter of 1973 of 96.2 percent. As of the first quarter of this year, this index had dipped to 78.5 percent. At this level, it was still above the lows of 73.3 percent and 74.2 percent, respectively, reached in the 1957-58 and 1960-61 recessions. Overall, judged in terms of unused plant and equipment capacity, the current level of excess capacity is substantial but not more so than in the two earlier major postwar recessions.

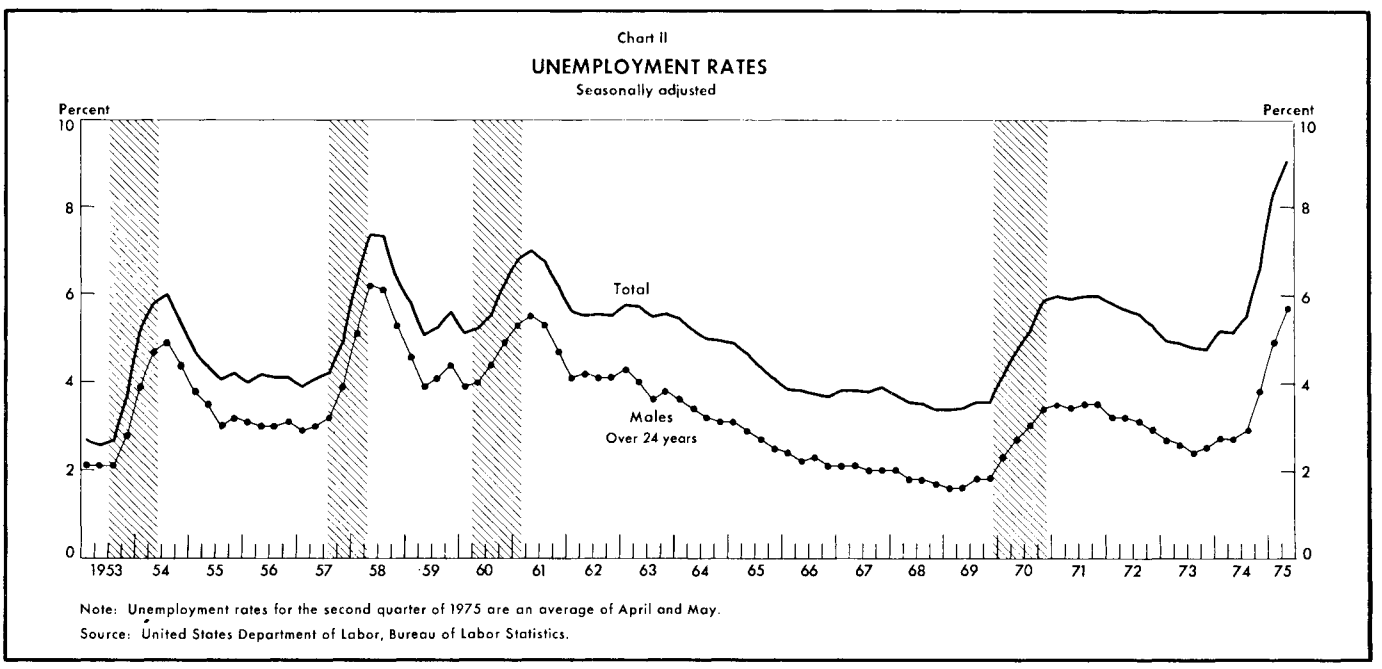
The most popular single measure of slack in the labor market is the overall unemployment rate (see Chart II). In May the jobless rate reached 9.2 percent of the civilian labor force, the highest level since 1941. However, this may exaggerate the current degree of labor-market slack to some extent, since any historical comparison is affected by the dramatic changes in the composition of the labor force that have occurred during the postwar period. For example, women and young men have higher average unemployment rates than adult men, in part because their attachment to the labor force is weaker. The proportion of women and young men in the labor force has increased substantially in recent years, and this has tended to raise the overall unemployment rate irrespective of the demand for labor. In comparing the current jobless rate with that of earlier years, it may be more meaningful to adjust the recent data for this shift in labor-force composition by restoring the relative importance of the major age-sex groups to, say, 1956 levels. On this basis, the current unemployment rate equals 8.1 percent, which is just slightly higher than the peak rates of 1958 and 1961. Moreover, at 5.8 percent in May, the jobless rate for men aged twenty-five and above is about equal to the peak rate in 1961 but below the 1958 rate. At least in some respects then, current labor-market slack is roughly comparable to the 1958 and 1961 situations.

## APPROPRIATIONS, MANUFACTURERS' ORDERS, AND INVENTORIES

According to the Conference Board's survey of the 1,000 largest manufacturing firms, appropriations for new plant and equipment dropped 9.4 percent in the first quarter of this year. And over the six-month period ended in March, newly approved appropriations fell 33.2 percent, the largest two-quarter decline since 1957. Reduced spending plans by durable goods manufacturers were entirely responsible for the latest slide, as appropriations by nondurable goods producers picked up somewhat. Cancellations of previously approved projects have also stepped up markedly in these two quarters, primarily because of postponements in the spending plans of the petroleum industry. As a result, net new appropriations are currently at the lowest level in two years.

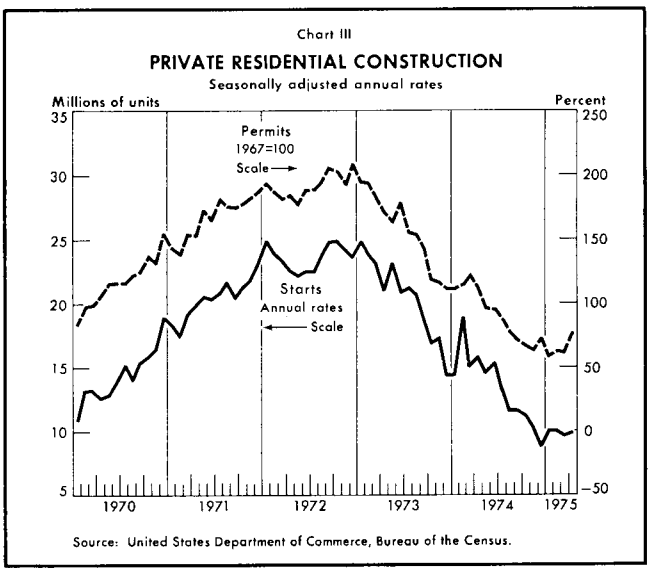
The flow of new orders received by durable goods manufacturers surged upward by 9.7 percent in April. Although new bookings were still 21 percent below the peak reached last August, the most recent increase was the largest in more than seven years, and it raised durables bookings to the highest level since last November. Despite this jump, shipments rose even faster and the backlog of unfilled orders fell to the lowest level in one year.

Historically, a sustained increase in durables orders has



typically been a forerunner of increases in production. While the April advance could of course be reversed in subsequent months, orders have now increased in two of the last three months, thus providing some support for the view that the economy appears poised for recovery. This conclusion seems more likely, since the April jump in orders was widespread among all industrial sectors. Bookings for transportation equipment registered the largest advance, but the increase in bookings for machinery and primary metals was also sizable. Orders for nondefense capital goods also jumped for the first time since last September. However, while the increase was rather large, orders for nondefense capital goods just barely managed to climb above the level recorded four months ago.

Manufacturers succeeded in reducing inventories of both durable and nondurable goods in April for the second consecutive month. With stocks falling by $1.15 billion, this latest round of inventory liquidation exceeded the previous month's drop and was the largest in percentage terms since May 1958. Declining inventories of nondurable goods accounted for most of the drop, as stocks of both finished goods and materials fell by a sizable margin in this sector. While the ratio of nondurable inventories to sales is now at its lowest level since last November, stocks of durable manufactured goods still seem to be high in relation to current sales. In April, manufacturers' inventories of durable goods declined only modestly, as a reduction in materials and supplies offset increases in work in progress and in finished goods inventories.




## PERSONAL INCOME, RESIDENTIAL CONSTRUCTION, AND RETAIL SALES

Personal income rose $6.7 billion in April, the largest increase thus far this year and just slightly below the $7 billion monthly rise averaged during 1974. Income in the private sector remained unchanged in the month, however, as a small increase in the payrolls of service industries was offset by a decline in income in the distributive industries. Manufacturing payrolls stabilized in April, after posting a small increase in March. Prior to this, manufacturing payrolls had been reduced considerably so that in April they were 7.4 percent below the peak of last October. Government payrolls, meanwhile, rose slightly as a result of expanded employment under public service job programs. Among nonwage earners, small gains were posted by all groups, with the rise in transfer payments especially modest in comparison with previous months. Finally, reflecting an increase in farm prices, income of farmers grew $1.7 billion in April but the advance still left farm income 38 percent lower than it was a year ago.

Weakness in residential construction persisted in April, as housing starts rose only modestly above the sluggish pace of the previous month (see Chart III). At 990,000 units in April, starts were 37 percent below the level of a year earlier. However, there are signs that a modest upturn in housing construction may soon begin. Thus far this year, housing starts have consistently been above last December's depressed level. Moreover, in April, newly issued building permits jumped 27 percent above those of March and were higher than at any time since last August. Also, there is some evidence that the recently passed tax credit for purchases of new homes built or under construction before the end of March is cutting into the inventory of unsold homes. The combination of an increase in sales and a reduction in the number of homes available for sale lowered the backlog to 10.6 months in March, well below the 11.7 months averaged over the previous six months. On the other hand, mortgage interest rates are still very high and, despite the large volume of funds flowing into thrift institutions, the cost of financing a new home is only slightly below what it was one year ago. In coming months the behavior of mortgage interest rates as well as the growth in real income and changes in housing prices will be important in determining the strength of the housing recovery.

Retail sales advanced $647 million in April, after slump-

ing rather sharply in March. Of course, the dollar volume of sales has been quite volatile in the past months, and consumer spending in April was only a little above the level of last July. Expenditures on durable goods rose slightly during the month, but they were nevertheless well below the average of the initial quarter of 1975. The reason for this is that in January and February widespread clearance sales and the automobile industry's cash rebate program boosted sales substantially. Over the entire first quarter, domestic auto sales averaged 6.6 million units but, upon the termination of the rebate program, sales slumped to 5.7 million units in April. Although an improvement was evident in May, auto sales were still running well below the industry's expectations. Spending on nondurables increased by nearly $300 million in April to a level 8.5 percent above that of a year earlier.

## PRICE DEVELOPMENTS

Prices moved up irregularly in the past few months, but further indications of an abatement in underlying inflationary pressures were evident. At the retail level, inflation accelerated in April largely because of a spurt in food prices. Wholesale prices rose more slowly in May than they had in the previous month, however, with the advance in industrial commodity prices being about in line with the moderate increases registered in previous months.

Consumer prices jumped at a 7.1 percent seasonally adjusted annual rate in April, nearly double the advance of the previous month. Nevertheless, retail prices have increased only 5.7 percent over the three-month period ended in April, the mildest three-month advance since the beginning of 1973. Food prices, which declined in each of the two preceding months, reversed course in April and rose at a 4.2 percent annual rate. At the same time, higher prices for used cars and power and fuel paced a 9 percent annual-rate advance in consumer nonfood commodity prices. Although this was a bit higher than the advance experienced over the first quarter of this year, it was less than the 13.4 percent rise recorded in 1974. Finally, prices of consumer services rose at a 6.6 percent annual rate in April. This increase was about equal to the rise in the last three months, and it was mainly attributable to higher prices for transportation and medical care.

After jumping sharply in April, wholesale prices rose at a 4.2 percent annual rate in May. These increases, which reversed a decline that began last December, were precipitated by large boosts in prices of farm products and processed foods and feeds. The 7.3 percent annual-rate advance in farm and food prices in May was led by an increase in prices for livestock and poultry. Although prices of meat and poultry are expected to continue rising through the summer months, further large increases in food prices may be tempered by the expectation of record feed grain crops. While adverse weather conditions initially delayed corn plantings, prospects still appear good for a record crop. Furthermore, according to the latest Department of Agriculture forecast, this year's wheat crop is expected to be even larger than last year's record.

Meanwhile, wholesale prices of industrial commodities, which are generally considered to be a more accurate barometer of inflationary pressures, continued to climb only modestly. In May, industrial wholesale prices edged up at a 2.1 percent annual rate and, excluding power and fuel, industrial commodity prices remained unchanged over the last three months. To a large extent, this moderation reflects the large decreases in prices of raw materials that occurred earlier in the year. More recently, spot prices of raw industrial commodities have started to fall again so that there may well be a further abatement in inflation. At later stages of fabrication, prices of intermediate materials declined in May for the first time in nearly two years, while the increase in consumer finished goods prices remained below the advance of the last six months.

# The Business Situation

Evidence continues to accumulate that recessionary forces in the economy are dissipating. Indeed, the end of the worst postwar recession either is close at hand or already has occurred. The new composite index of leading indicators posted a substantial gain in May, following a very large rise in the preceding month and a small advance in March. In the past, this index has typically led upturns in general economic activity by only two months or so. Elimination of the remaining overhang of inventories would lay the groundwork for an economic recovery, and progress on this front also has been made lately. In April the book value of manufacturing and trade inventories plunged by $1.8 billion, exceeding the average decline recorded in the two previous months. Industrial production slipped a bit further in May; however, the output of consumer goods increased for the second consecutive month. New orders for durable goods rose strongly in May, as did retail sales. Housing starts have shown modest improvement, and inroads have been made lately in reducing the backlog of unsold homes. Total employment rose in June for the third successive month, and the unemployment rate declined to 8.6 percent of the civilian labor force, down from 9.2 percent in May. However, the decline in joblessness was probably the result of statistical problems and therefore is an overstatement of the improvement in labor market conditions.

Recent price trends have been generally encouraging. While fuel prices have increased rather sharply in the past few months, other prices seem to be leveling off. Consumer prices rose at only a 4.2 percent annual rate in May, with prices of nonfood commodities edging up at a 2.4 percent rate. This was the smallest such rise in twenty-two months, and it resulted entirely from higher prices for consumer power and fuel. Wholesale prices declined at a 1.7 percent annual rate in June, as prices of farm products and related items decreased at a 16.5 percent annual rate. Prices of industrial commodities rose at a faster rate than in the last several months. Despite this acceleration, underlying inflationary pressures remain moderate since more than half the 4.6 percent rise in industrial commodity prices in June was attributable to higher energy prices.

## INDUSTRIAL PRODUCTION, LEADING INDICATORS, ORDERS, AND INVENTORIES

Industrial production declined for the eighth consecutive month in May (see Chart I), leaving output in the nation's factories, mines, and utilities 13 percent below the level attained last September. Including the modest 0.3 percent May slippage, the current slide in production now amounts to the longest sustained drop in seventeen years. Nonetheless, compared with the 8 percent contraction in production averaged in the first quarter of this year, the mildness of the declines in April and May seems to be pointing toward a bottoming-out of the current contraction. The decline in May resulted chiefly from a further fall in the production of business equipment and materials. Output of consumer goods, on the other hand, increased for the second successive month, as production of durable goods advanced sharply. Stepped-up production of automobiles accounted for most of the rise, although output of appliances and furniture also rose during the month. In June the output of passenger cars continued to increase to the highest level since last November.

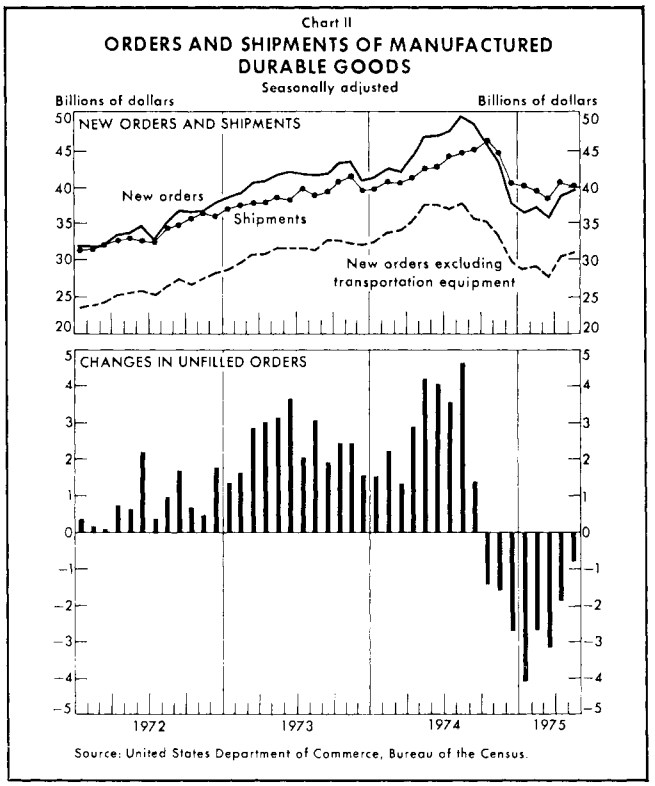
In May the Government's revised index of leading economic indicators rose 2.1 percent, a somewhat smaller increase than the advance posted in the previous month. The index currently stands at its highest level since last November, but it is still 25 percent below the peak registered in the middle of 1973. Nonetheless, the leading indicators have increased for three consecutive months, the most sustained advance since July 1973. In the past, a three-month rise after a sustained decline has invariably been followed by the end of a recession, so that the most recent increase strongly suggests the current economic downturn is ending. Of the ten indicators available for May, eight rose while the remaining two were unchanged.

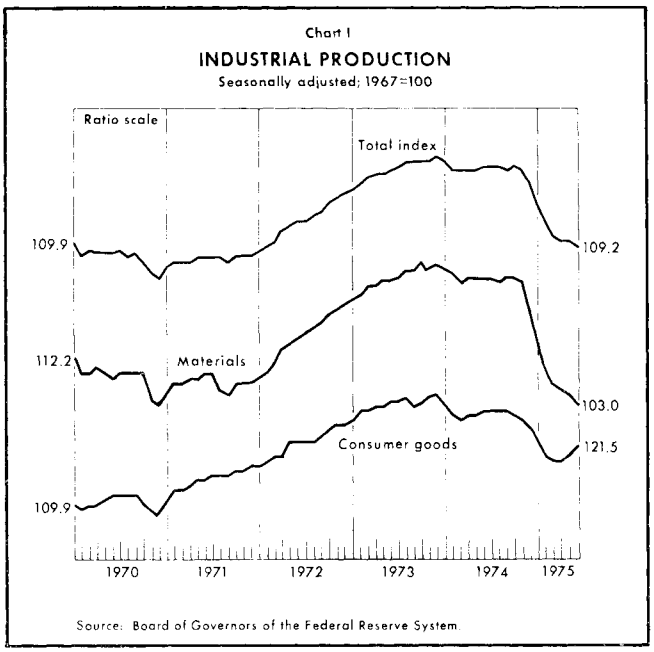
New orders for durable goods rose $498 million in May, continuing an uptrend that initially surfaced last February (see Chart II). However, the rise was neither so large as the surge in April nor so broadly based. Much of the May increase was centered in orders for primary metals, while bookings for machinery and capital goods

rose only moderately. Orders for household durable goods were essentially unchanged during May, as were bookings for transportation equipment. Shipments of durables declined during the month, but they still remained higher than the level of new orders. Consequently, the backlog of unfilled orders dropped for the eighth consecutive month.

The book value of total business inventories fell in April by $1.9 billion. This decline was slightly more than that recorded in the preceding month, and it marks the first time since 1961 that stocks have fallen for three consecutive months. Business sales, meanwhile, climbed 2.1 percent in April, after falling in four of the five previous months. Consequently, the ratio of inventories to sales equaled 1.65 months in April, down from 1.7 months in March. At this level, the stock-sales ratio in April was at its lowest reading since last November though still well above the 1.46 months of sales reached one year ago.

The accelerating pace of inventory liquidation was fairly widespread. In April, inventories held by manufacturers fell $1 billion, and in May the reduction was even larger. At the wholesale level, stocks fell by about $0.5 billion in April, which was well above the decumulation averaged in the previous three months. Retailers, on the other hand, worked off inventories at only a fraction of the rate recorded earlier in the year. Stocks of nondurable goods at retail outlets were liquidated at a rapid rate, but inventories of durable goods, which dropped sharply in the January-March period, were essentially unchanged in April because of a renewed buildup in stocks of unsold automobiles.




## PERSONAL INCOME, CONSUMER DEMAND, AND RESIDENTIAL CONSTRUCTION

Personal income rose $9.3 billion in May, as both public and private sector payrolls expanded. The increase was the largest since last September and, coupled with the distribution of tax rebates and lower withholding rates, may provide a boost to consumer spending. Government payrolls rose modestly in May, but private sector wage and salary disbursements increased by a hefty $3.4 billion. Virtually all of this was concentrated in the service and distribution industries. Manufacturing payrolls edged up only slightly in May, remaining well below the level of last January. Moreover, this small increase was centered in expanded payrolls of nondurable goods producers, as wage and salary outlays of durable goods producers continued to contract.

Consumer demand at retail outlets climbed 2.2 percent in May, as expenditures on both durable and nondurable

goods registered impressive gains. Current-dollar sales have increased in five of the last six months, with the most recent advance the largest in percentage terms since January. Spending on durable goods rose $377 million in May primarily because of higher outlays for automobiles. Although passenger car sales are still depressed, demand has slowly but steadily picked up in recent months. Auto sales jumped 8.8 percent to 6.2 million units in May and, in June, sales rose to the highest level since February. Finally, spending on nondurables jumped by more than $600 million in May, the sharpest monthly advance in nearly two years.

The housing picture also appears to have brightened in May. Housing starts rose 14 percent in May to a seasonally adjusted 1.1 million units, the highest level in eight months. Moreover, newly issued building permits rose for the second consecutive month in May and are now higher than at any time since last August. But, while a housing recovery seems to be in progress, residential construction activity has been extremely weak and the number of housing starts in May was 23 percent below the year-earlier level. However, the upturn may strengthen somewhat in coming months, since the volume of unsold homes has been reduced sharply. In April, sales of new single-family homes jumped 25 percent as the recently passed tax credit for new-home purchases went into effect. Combined with a further reduction in the number of homes available for sale, the backlog fell to 8.1 months in April, the lowest level in almost two years.

## PRICE DEVELOPMENTS

Consumer prices rose at a 4.2 percent seasonally adjusted annual rate in May, as the rate of price increase of nonfood commodities and services moderated considerably. Over the three months ended in May, retail prices advanced at a 4.9 percent annual rate, the smallest three-month rise since the period ended January 1973. Nonfood commodity prices edged up at only a 2.4 percent annual rate in May, the smallest increase in twenty-two months. Consumer energy prices rose sharply in May, however, and, if these are excluded, nonfood commodity prices were unchanged in the month. Meanwhile, increases in the cost of medical care and rents pushed prices of services up at a 2.9 percent annual rate in May, the smallest advance in nearly two years. Food prices, on the other hand, have started to increase more rapidly. In May, retail food prices rose at a 6.3 percent annual rate, a somewhat more rapid rate than in April. This acceleration, which was attributable to large hikes in prices of meats and poultry, was not surprising in light of recent movements in farm prices at the wholesale level.

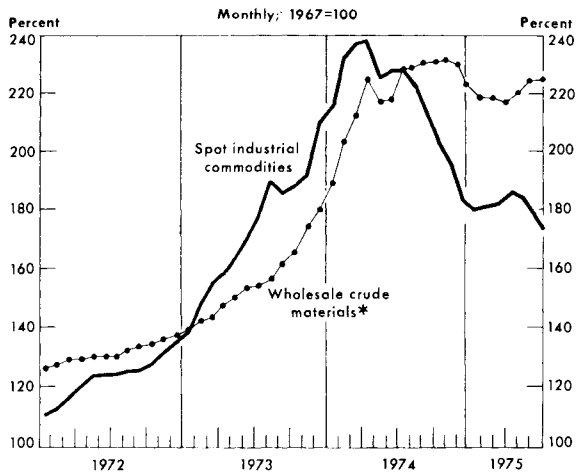
Wholesale prices declined at a seasonally adjusted 1.7 percent annual rate in June, after rising in each of the previous two months. The easing in prices was due entirely to a 16.5 percent annual-rate decline in prices of farm products and processed foods and feeds. Prices of livestock and poultry continued rising in June, but these increases were offset by fairly large declines in prices of the major feed grains. Industrial commodity prices advanced at a 4.6 percent annual rate in June, somewhat faster than in the last few months. Nevertheless, this does not appear to signal a broad resurgence in inflationary pressures since the acceleration mainly reflected higher energy prices. Indeed, industrial commodity prices excluding power and fuel rose at only a 2.2 percent annual rate in June. Increases in energy prices also contributed significantly to a 6.4 percent rise in crude material prices in that month. Since energy prices began rising again rapidly three months ago, wholesale prices of crude materials have jumped at a 14.1 percent annual rate.

Movements in crude material prices typically parallel changes in spot prices of industrial commodities. For example, beginning in 1972 and extending through four months of 1974, the run-up in commodity prices was matched by sharp increases in prices of crude materials (see Chart III). Dramatic increases in scrap metal prices were principally responsible for this commodity price

Chart III

PRICES OF INDUSTRIAL MATERIALS

Monthly; 1967=100




* Seasonally adjusted.

Source: United States Department of Labor, Bureau of Labor Statistics.

spiral. The spot metals index, which accounts for approximately one half of the entire industrial spot price index, rose more than 80 percent from the middle of 1973 to mid-1974. This was characterized by nearly a threefold increase in the price of scrap steel as well as significant increases in the prices of other metals. Prices of textiles and other raw industrial commodities, meanwhile, rose only modestly. By May of last year, market pressures began softening somewhat, and spot prices started falling, while the rise in crude material prices leveled off. Since November both series generally have moved together, but in May and June industrial spot prices fell while prices of crude materials spurted somewhat.

There are several factors which account for much of the discrepancy in these movements. Unlike wholesale prices, spot market prices are not seasonally adjusted. Also, the various commodities included in the spot market index are equally important, while the relative importance of each wholesale crude material commodity varies. Indeed, scrap metal prices amount to only about 20 percent of the wholesale price index for crude materials but nearly one half of the spot price index. Thus, if metal prices are rising or falling very rapidly while other prices are registering small changes, the spot price index will be affected more than wholesale crude materials.

More broadly, it should be emphasized that the composition of the two series differs. In particular, prices of crude petroleum and bituminous coal are excluded from the spot price index but are part of the wholesale crude materials index. Conversely, prices of textiles are included in the spot market index, but they do not appear in the index for wholesale crude materials. These differences became very significant beginning in the summer of 1974, when a huge gap in the two measures opened up. A plunge in metal prices and a moderate drop in prices of textiles pushed spot prices down sharply. However, a similar decline in wholesale crude material prices was prevented by sharp increases in energy prices. More recently, further increases in energy prices have again caused spot and wholesale prices to move in opposite directions. In fact, a rise in energy prices accounts for most of the increase in prices of crude materials during May. If energy prices are excluded, crude material prices barely changed at all in that month. Hence, the rise in prices of crude materials does not alter the fact that inflationary pressures are moderating. Certainly the recent movement in industrial spot prices suggests that the market for most basic commodities is still rather weak.

## LABOR MARKET DEVELOPMENTS

Unemployment declined to 8.6 percent of the civilian labor force in June, after reaching 9.2 percent in the preceding month. This was the first drop in more than one year, and the jobless rate is now the lowest since February. Whether this does in fact mark a definite improvement in labor market conditions is questionable, though, since the unemployment rate has been distorted by faulty seasonal adjustment procedures in the last two months. Subsequent revision will probably show that the jobless figures initially reported were too high in May and too low in June. Nevertheless, the total number of employed persons did rise again in June, although not by as much as in May, and most of the major categories of workers experienced lower unemployment in June. On the other hand, the percentage of those unemployed for more than fifteen weeks rose to 3.1 percent of the civilian labor force, the highest since the series began in 1948.

The separate survey of nonfarm establishments suggests that the labor picture was essentially unchanged in June. Total payroll employment edged up slightly during the month, as payrolls in the trade, finance, and services industries all increased. Government payrolls also expanded slightly in June, but this may not persist in light of recent budget cutbacks among states and localities. Meanwhile, the number of employees in construction fell by 52,000 persons in June. Manufacturing employment also declined slightly, after rising in May. The drop in June, however, was not nearly so large as the declines in manufacturing payrolls registered earlier in the year.

# The Business Situation

Economic activity steadied in the second quarter of 1975, following five consecutive quarters of significant decline. While the gross national product (GNP) in real terms dropped again, the reported decline was negligible and was more than completely accounted for by an intensification in the rate of inventory liquidation. Indeed, the latest GNP data suggest that the longest and steepest postwar recession has finally bottomed out. Although the inventory liquidation may well continue for sometime further, it seems clear that businessmen have been successful in bringing stocks into better alignment with sales. Buoyed by consumption spending, final demand as a whole rose in real terms in the second quarter for the first time since mid-1973. As a result of lower income taxes and increased transfer payments, consumers were able to expand their purchases and at the same time to rebuild liquidity. Elsewhere, outlays on housing stabilized in real terms, but business fixed investment spending continued to decline. Conditions in the labor market improved in July as employment rose and the unemployment rate declined to 8.4 percent of the civilian labor force.

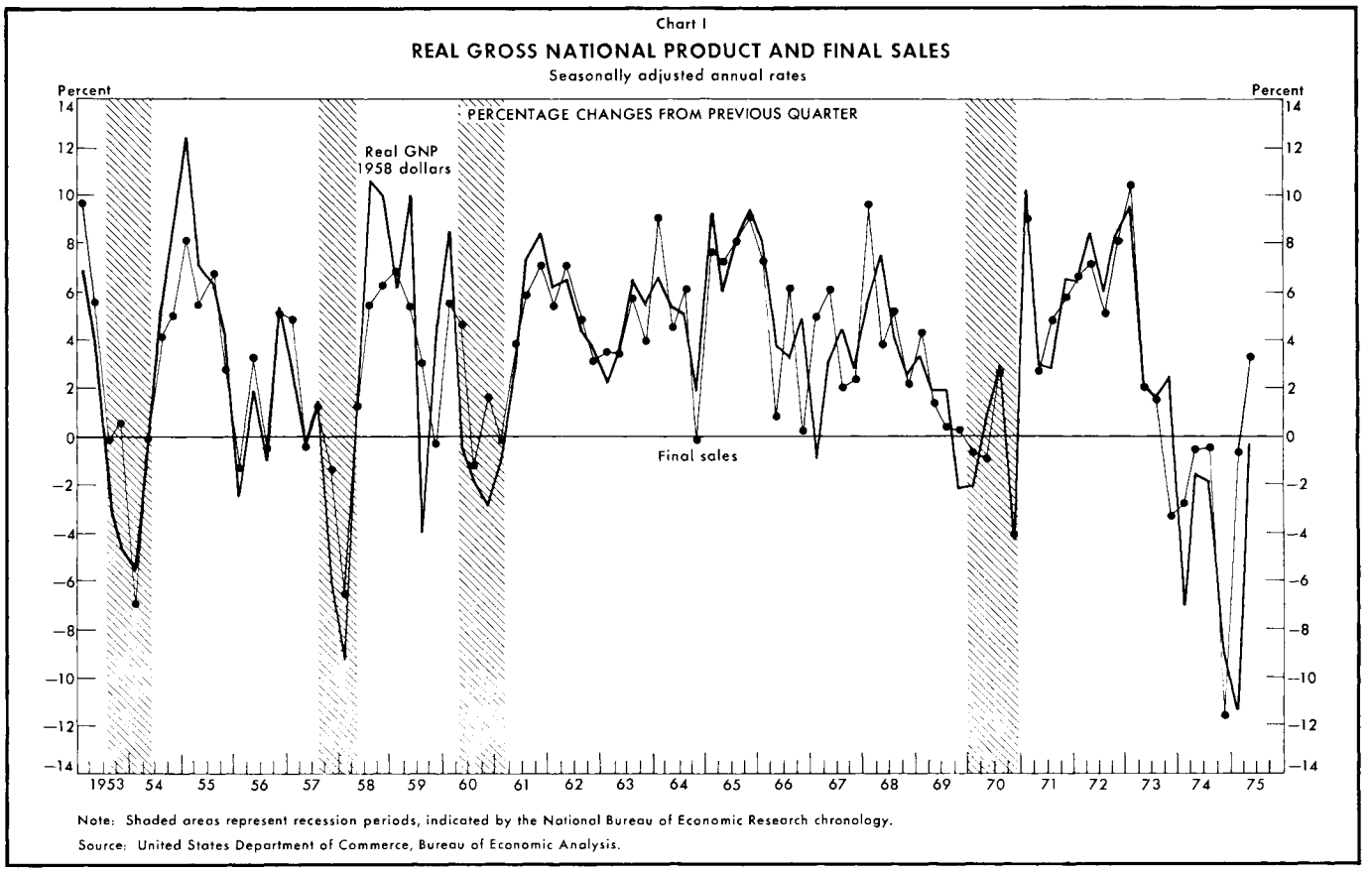
On the inflation front, the latest evidence indicates that the deceleration in inflation which began in the fourth quarter of last year extended into the April-June period. The rate of growth of the fixed-weight price index for GNP—which, unlike other GNP deflators, is unaffected by compositional shifts in output—was 6 percent in the second quarter, 1.5 percentage points below the increase in the previous quarter and the lowest recorded since the fourth quarter of 1972. However, recent and prospective developments cast some doubt on whether this favorable trend will continue. While industrial commodity prices have moderated in the face of mounting unused capacity and inventory liquidation, prices of petroleum products and fuel have recently been climbing at a somewhat accelerated pace. Another discouraging factor has been the recent acceleration in food prices. Moreover, spot and future prices of agricultural commodities have jumped in response to reports of large foreign grain purchases. On the wage front, the latest evidence suggests that the slack in the labor market has begun to dampen the growth of wages. The growth of compensation per hour worked decelerated in the second quarter and, coupled with increased labor productivity, the rate of increase in unit labor costs slowed considerably.

## GNP AND RELATED DEVELOPMENTS

According to preliminary data released by the Department of Commerce, the market value of the nation's output of goods and services rose by $16.8 billion in the second quarter, a 4.8 percent seasonally adjusted annual rate of gain. After adjusting for the effects of higher prices, real GNP inched down at an annual rate of 0.3 percent, in sharp contrast to the 11.4 percent plunge in real GNP in the preceding three-month period (see Chart I). On balance, real GNP in the April-June quarter stood 7.8 percent below the peak attained in the final three months of 1973. This is the longest and steepest drop recorded during any postwar recessionary period.

As in the first quarter, the rapid pace of inventory liquidation was the most important depressant on economic activity. Current-dollar final expenditure—i.e., GNP less the change in inventories—rose $31.3 billion, or 9 percent, at an annual rate. In real terms, the increment in final sales amounted to 3.3 percent at an annual rate, the first such gain in six quarters. The increase in real spending resulted from advances in consumer, residential construction, and government outlays that more than offset the drop in business fixed investment.

Preliminary estimates based on partial data indicate that inventory liquidation accelerated to a record rate in the second quarter. In current-dollar terms, businesses reduced their inventories by $33.7 billion, outpacing the very large




$19.2 billion decline in the first quarter. Despite this massive inventory liquidation, the $14.5 billion restraint on GNP expansion was much smaller than the $37 billion drag in the first quarter, when inventory investment swung from accumulation to decumulation. Although the massive inventory correction acts as an immediate depressant on economic activity, in the long run the liquidation is essential for an eventual pickup in production.

In the first quarter, about half of the swing to liquidation was accounted for by real retail auto inventories. In contrast, inventory liquidation in the April-June interval was much more broadly based, with all major categories posting sizable declines (see Chart II). In retrospect, it appears that the inventory correction commenced late in 1974 in the nondurables trade sector and has spread since then to all major sectors of the economy. Thus, in the second quarter of this year, inventory reductions occurred in the durable and nondurable manufacturing, wholesale, and retail trade sectors. As a result of the massive inventory liquidation and the recent pickup in final sales, the ratio of constant-dollar inventories to final GNP sales has now receded from the extraordinarily high level to which it had risen at the end of 1974. While imbalances probably still remain in certain sectors of the economy, especially durable manufacturing, the overall inventory situation is now vastly improved over what it was at the beginning of the year.

There was in the second quarter a marked improvement in final sales, spurred by a sharp rise in disposable income. Consumers' disposable income surged by $63.3 billion in the second quarter, as tax rebates, cuts in tax-withholding rates, and special supplemental social security transfers swelled spendable income. The jump in disposable income stemmed from a $27.4 billion increase in personal income, coupled with a $36 billion drop in personal tax payments. Part of the gain in personal income was at-

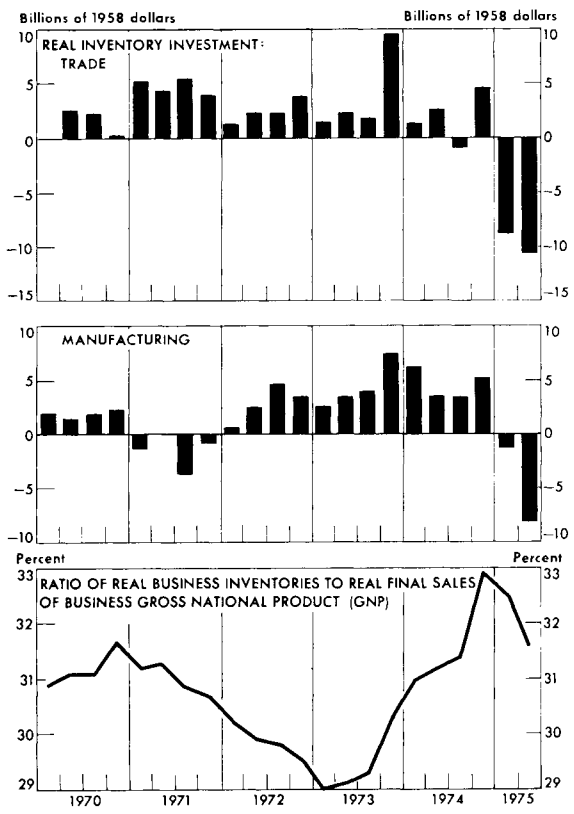
tributable to onetime payments of $50 to social security recipients, while tax rebates amounted to $31.7 billion at an annual rate. Together with an easing in the rate of inflation, real disposable income rose at a 22 percent seasonally adjusted annual rate.

Personal consumer expenditures increased by $24.9 billion in current-dollar terms (see Chart III). In real terms, the gain in personal consumption expenditures was the largest since the first quarter of 1973. With disposable income increasing sharply and consumption spending increasing more moderately, the saving rate soared to 10.6 percent of disposable income, the highest rate of saving since the first quarter of 1946 and well above the 7.5 percent averaged over the previous four quarters. While this accumulated saving is likely to be used initially by consumers to reduce instalment debt and rebuild liquidity, it will at the same time provide a foundation for stronger consumer spending in future months. Moreover, the impact of lower withholding schedules and extended unemployment benefits will continue to be felt in the future, and an 8 percent cost-of-living increase in social security benefits will also boost disposable income. The gain in real consumer spending reflected higher outlays for durable and nondurable goods as well as for services. Real service expenditures increased at a 4.8 percent annual rate. Real spending on consumer durables rose at a 10 percent annual rate in the June quarter, with auto expenditures expanding at a 9 percent annual rate and nonauto spending rising at a 10.5 percent annual rate. Sales of domestically produced cars have edged up steadily in recent months, running at 7.1 million units in June as compared with the 6 million units sold in March. Nondurable goods outlays rose at a 6.3 percent annual rate, the largest increase since the fourth quarter of 1972.

Chart II

REAL INVENTORY INVESTMENT AND REAL INVENTORY-SALES RATIOS IN THE GNP ACCOUNTS

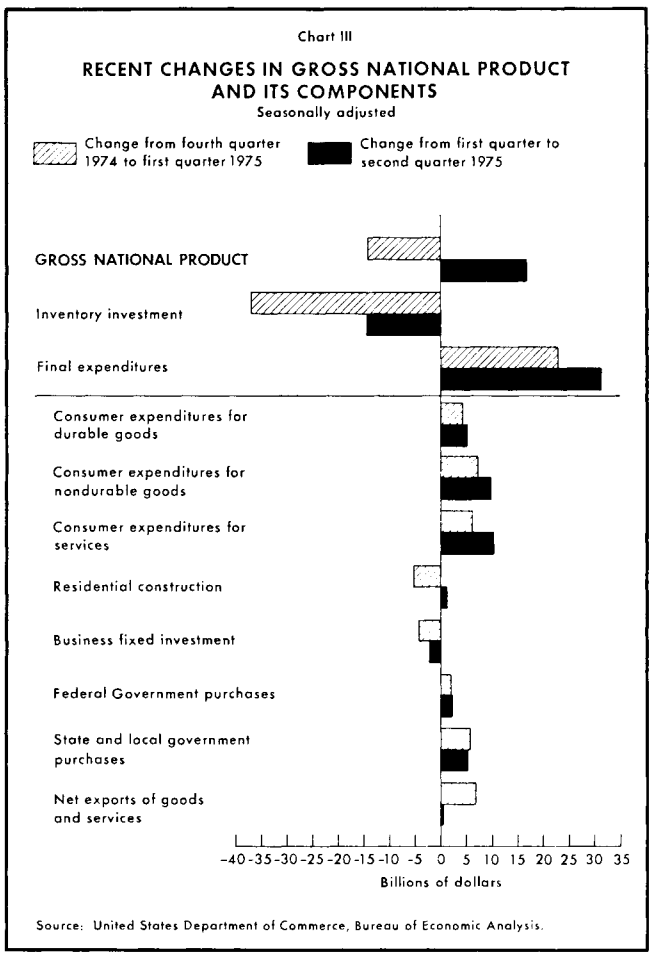
Seasonally adjusted annual rates




Source: United States Department of Commerce.

After skidding for two years, real residential construction spending edged up in the second quarter. To be sure, the increase was negligible, but it nonetheless suggests that the collapse in housing has ended. Most other measures of housing activity confirm the pickup in home building, but the strength of the recovery is still uncertain. Permits to build new homes rose each month of the quarter and, over the quarter, averaged 892,000. While this remains a depressed rate by historical standards, it is 30 percent higher than the first-quarter average. Another encouraging factor has been the improvement in sales of single-family homes. Sales are now at their highest level since May 1974. No doubt the tax credit on purchases of new, previously unoccupied houses is a factor in the sales pickup. On a newly built home of $40,000, which is close to the median price of new one-family homes, the 5 percent tax credit works out to be roughly equal to a 20 percent reduction on a 25 percent downpayment. The ratio of unsold new homes to sales fell in May to its lowest level in nearly two years. Despite the recent upturn of short-term interest rates, rates on time and savings deposits have remained relatively attractive and deposit growth at thrift institutions has continued to accelerate. In June, deposits at savings and loan associations and mutual savings banks rose at close to a 20 percent annual rate. Thus, the outlook for housing remains moderately encouraging, as the increased inflow may lead to further easing in mortgage lending terms.

Business fixed investment declined $2.3 billion in the second quarter, as the drop of $2.6 billion investment in structures more than offset a $0.2 billion increase in producers' durable equipment. In real terms, plant and equipment outlays fell for the fourth consecutive quarter.




In light of the current low levels of capacity utilization, there is little reason to look for a turnaround in spending. Indeed, the most recent Commerce Department survey of capital spending plans, taken in late April and May, indicates such a meager increase in nominal outlays in 1975 that a decline in real terms seems certain. Outlays on new plant and equipment are expected to be only 1.6 percent higher than in 1974.

## PRICE DEVELOPMENTS

By virtually every measure, inflation continued to decelerate over the April-June period. Prices of goods and services, as covered by the implicit GNP price deflator, advanced at a 5.1 percent annual rate in the second quarter, down substantially from the 8.4 percent advance recorded in the previous three-month period. In part, however, it appears that the slowdown in the implicit GNP deflator overstated the actual improvement because of the changing composition of output, especially the sizable pickup in the level of auto production between the first and second quarters. The fixed-weight price index, which holds constant the composition of output, improved more modestly, with its annual rate of increase falling from 7.5 percent in the first quarter to a 6 percent rate in the second quarter.

To the relief of consumers, the rate of inflation in retail prices is now running well below the double-digit range. Since peaking at an 11.9 percent annual rate in the third quarter of 1974, the rate of advance of consumer prices has eased considerably. In the second quarter, such prices rose at a 5.8 percent annual rate, the slowest quarterly rate of increase since the end of 1972. This deceleration reflected a sharp slowdown of inflation in the prices of nonfood commodities and services, as well as food. However, it appears that the volatile food component is headed back up. Led by rapid increases in the price of meat, the increase in food prices accelerated each month of the quarter. Nonfood commodity prices rose at a 6.7 percent annual rate over the quarter, less than half of the 13.6 percent rate of increase a year earlier. Service prices in the second quarter rose at a 6.1 percent annual rate, compared with a 9.3 percent annual-rate advance in the previous quarter.

At the wholesale level, prices of industrial commodities continued to decelerate, rising at a 2.6 percent annual rate over the April-June period. This was in sharp contrast to the year-earlier quarterly increase that exceeded 30 percent at an annual rate. The deceleration would have been even more pronounced if power and fuel prices had not begun to rise rapidly again. Unfortunately, the near-term outlook for energy prices is not encouraging. The full impact of import fees of $2 per barrel on crude oil and 60 cents per barrel on refined petroleum products is still to be felt and undoubtedly will add to pressures on energy prices. In addition, energy prices could accelerate even further in the event that either domestic crude oil prices are decontrolled or the Organization of Petroleum Exporting Countries (OPEC) cartel raises its price of oil. Excluding power and fuel, industrial commodity prices rose only at a 2.2 percent annual rate in June. After declining in the first three months of 1975, wholesale agricultural prices increased at a 16 percent annual rate in the second quarter. As a consequence, wholesale prices as a whole rose at a 7 percent annual rate in the second quarter after declining in the first quarter. To a large extent, the turnaround in agricultural prices reflected a jump in the prices of livestock and meat, as prices of hogs and

beef cattle have soared recently.

In July the outlook for food prices was clouded by reports of drought damage to USSR crops and by news that the Soviets were seeking to purchase substantial amounts of wheat and corn from the United States. Despite forecasts of record domestic production of corn and wheat, prices of these commodities have jumped sharply. As of the end of July, the USSR had contracted to purchase 9.8 million metric tons of domestic wheat, corn, and barley. Although it is clear that the increased Soviet demand for United States grain exports will lead to higher prices of corn and wheat, it does not appear that these purchases will precipitate the skyrocketing prices of 1972-73. With the exception of the USSR, prospects for an increase in worldwide production appear good, and production estimates suggest that carry-over stocks in this country at the end of the year will likely be larger than at the beginning.

## WAGES, PRODUCTIVITY, AND EMPLOYMENT

Recent data indicate that the pace of wage increases has slowed in the past several months. Over the April-June interval, compensation per hour worked, which includes wages and fringe benefits, rose in the private nonfarm sector of the economy at a seasonally adjusted annual rate of 7.2 percent, a slower pace than the 10 percent increase averaged in the previous four quarters. The slowdown in wage gains has also been mirrored in other wage series. Average hourly earnings increased at a 5.1 percent annual rate in the second quarter, compared with an 8.5 percent advance recorded in 1974. However, because movements in this series reflect not only wage changes but also changes in manufacturing overtime and interindustry shifts in employment, a better measure of wage-rate changes is the adjusted hourly earnings index. After adjusting for changes in overtime in manufacturing and interindustry shifts, the gain in average hourly earnings slowed to 6.9 percent at a seasonally adjusted annual rate in the second quarter, the third consecutive quarter of slower wage gains and the lowest rate of increase since the first quarter of 1974. Over 1974 as a whole, adjusted average hourly earnings climbed at a 9.1 percent rate.

Developments reported in the separate survey of major collective bargaining agreements also reveal a modest slowing in the rate of wage increases, although the gains remain sizable. In collective bargaining agreements covering 5,000 or more workers, contracts settled in the second quarter provided for a 9.3 percent annual rise in wages and benefits over the first year of the contract and 7.7 percent annually over the contract life. In contrast, the increases in contracts signed in 1974 averaged 10.7 and 7.8 percent, respectively. For wages alone, settlements covering 1,000 or more workers in the second quarter provided for first-year increases of 9.8 percent, compared with 12.5 percent in the preceding three-month period. Because union negotiators have concentrated on winning large first-year wage increases, the relatively light calendar of major contracts that expire in 1975 should tend to help moderate wage pressures, since most union workers will be receiving the relatively smaller second- and third-year increases provided by agreements signed in earlier years. This tendency is reflected in the Bureau of Labor Statistics' effective wage series, which includes gains arising from current settlements, deferred increases negotiated in earlier years, and additional gains from escalator clauses. In the second quarter, the effective wage rate rose at a 7.8 percent annual rate after advancing 9.4 percent in 1974.

Productivity, as measured by output per hour of work in the nonfarm private economy, rose at a 3.4 percent seasonally adjusted annual rate over the April-June period, the first increase in more than two years. This advance, however, resulted from a decline in hours worked which exceeded the decline in total production. Typically, during the early stages of a cyclical recovery, productivity tends to pick up sharply as producers are able to utilize idle capacity more efficiently without large additions to their labor force. However, some analysts have argued recently that productivity increases in coming months may be subnormal for this phase of the business cycle since durable manufacturing industries may post smaller productivity increases than in typical recoveries. These analysts foresee only a modest recovery in the production of durable goods which ordinarily have bounced back sharply. In any event, the prospect of a moderate increase in unit labor costs this year looks promising since productivity growth, even if sluggish, is still likely to mitigate wage gains somewhat. In contrast, productivity declined continuously in 1974. In the second quarter, because of the deceleration in compensation and gains in productivity, unit labor costs in the private nonfarm sector rose at a seasonally adjusted 3.9 percent, the slowest annual rate of increase since late 1972 and far below the 14 percent advance posted in 1974.

According to the household survey, labor market conditions improved in July as the rate of joblessness fell to 8.4 percent. This was the second consecutive monthly decline and left the unemployment rate at its lowest level since February. Since the unemployment rate in June had been artificially depressed by faulty seasonal adjustment

procedures, it was widely expected that the jobless rate would post a substantial increase in July. Under these circumstances, it seems likely that the 0.2 percentage point decline in July may understate the actual degree of labor market strengthening. Despite this, the unemployment rate remains high by historical standards and, moreover, it remains to be seen if some of the improvement was an aberration. Typically, the unemployment rate tends to lag somewhat behind the pickup in economic activity, since employers expand production initially by lengthening the workweek of their work force without recalling laid-off workers or hiring new ones. In addition, as job prospects improve, this often encourages individuals who have stopped looking for employment to seek jobs, thus tending to swell the labor force and raise the rate of unemployment. Whatever the near-term behavior of the unemployment rate, employment has begun to expand. In July, total employment registered its fourth consecutive increase, advancing by 634,000 workers to its highest level in seven months. The number of unemployed persons fell in July to the lowest level since February. Most labor force groups shared in the improvement in employment; in addition, the number of persons working part time because they couldn't find full-time employment declined sharply in July, dropping by 175,000.

While the household survey points to an increased pace of employment growth, the separate payroll survey indicates a more modest advance in employment. Of course, the household and payroll surveys may diverge because of differences in definition, coverage, sources, and estimation procedures. In July, the survey of nonfarm establishments indicated that employment rose by 88,000 as employment in services, trade, and state and local government expanded. Employment in construction declined slightly but this may have reflected the effects of increased strike activity. Manufacturing employment also dipped slightly, but average weekly hours worked in manufacturing jumped to the longest workweek since November 1974. While the household survey points to a much faster employment growth than the payroll survey, the payroll survey nevertheless suggests that the employment gain was broadly based. The percentage of nonfarm industries experiencing increases in employment rose to 54.9 percent, the highest level in more than a year.

# The Business Situation

There now appears little doubt that the economy is emerging from the most severe postwar recession. Revised estimates of gross national product (GNP) confirm that a turnaround in economic activity occurred in the second quarter.* Even more importantly, the latest readings of the monthly business statistics suggest that the nascent recovery has been picking up momentum. Consumption spending has provided the essential base of the recovery, both directly by adding to the demand for final goods and indirectly by facilitating the liquidation of excessive inventories. Indeed, the massive inventory correction seems to be diminishing, although some inventory imbalances remain in certain sectors. In July, new durables orders rose for the fourth consecutive month and industrial production climbed for the second consecutive month. To be sure, capital spending and residential construction are lagging, but the beginnings of a recovery in home building are visible. Moreover, recent developments in the labor market have been, on balance, encouraging. Although the civilian labor force increased sharply in August, the rate of joblessness remained unchanged from the July level as employment advanced strongly.

The price situation, however, has taken a turn for the worse. After having eased a bit in earlier months of the year, the rise in the consumer price index, propelled by bulges in food and energy prices, advanced more sharply in June and July. Moreover, wholesale prices rose rapidly in August, as fuel and power prices jumped. Further increases are in the offing for some foods and for oil, aluminum, steel, and automobiles, despite the pronounced slack that still remains throughout the economy.

*In contrast to the slight decline in real GNP in the second quarter that had been indicated by the preliminary estimate, the revised data show a modest advance of 1.6 percent at an annual rate, the first increase since 1973. Inventory liquidation was revised downward from the preliminary figure, while final sales were revised upward primarily as a result of an upward revision in net exports. Released along with the GNP revisions was a preliminary estimate of pretax corporate profits (adjusted for changes in inventory valuation). This estimate shows a rise of $6.2 billion during the second quarter to a $100.5 billion seasonally adjusted annual rate.

## PERSONAL INCOME, CONSUMER SPENDING, AND RESIDENTIAL CONSTRUCTION

A $5.7 billion decline in personal income in July was the result of a special situation. The previous month, one-time payments of $50 had been made to recipients of social security, railroad retirement, and supplemental security benefits. These transfer payments had amounted to almost $20 billion at an annual rate, approximately three and one-half times the size of the July decline in total personal income. Wage and salary disbursements have been expanding in recent months, after having reached a nadir last February. In coming months, these disbursements should continue to rise, assuming employment continues to increase and the average workweek to lengthen. Aftertax income should grow even faster, as lowered withholding rates take effect in the second half of the year.

Consumption spending has recently been in the forefront of the recovery. Total retail sales increased $1.2 billion in July. Sizable advances had also been recorded in the preceding three months. As a result, for the four months ended July, growth amounted to 26 percent at an annual rate. Durable goods sales, led by a rebound in automobile sales, have accounted for the bulk of this upsurge in consumption spending. No doubt the recent gains in personal income, on an aftertax basis, have been a major factor in this advance. Just as important, but harder to measure, has been the diminution in the manifold uncertainties that have dogged consumers for some time, especially those related to inflation and employment prospects. This development may explain the appreciable improvement in consumer confidence recorded since late last year, as measured by the Conference Board and the Survey Research Center of the University of Michigan. It remains to be seen, however, what damaging effect the latest price acceleration might have on the growth of consumer spending. In any case, it seems clear that the recent strength in consumption spending has been instrumental in enabling retailers to pare their

inventory stocks to the point where little imbalance, if any, remains in this sector. Thus, consumption spending is having a dual effect in stimulating the economic recovery.

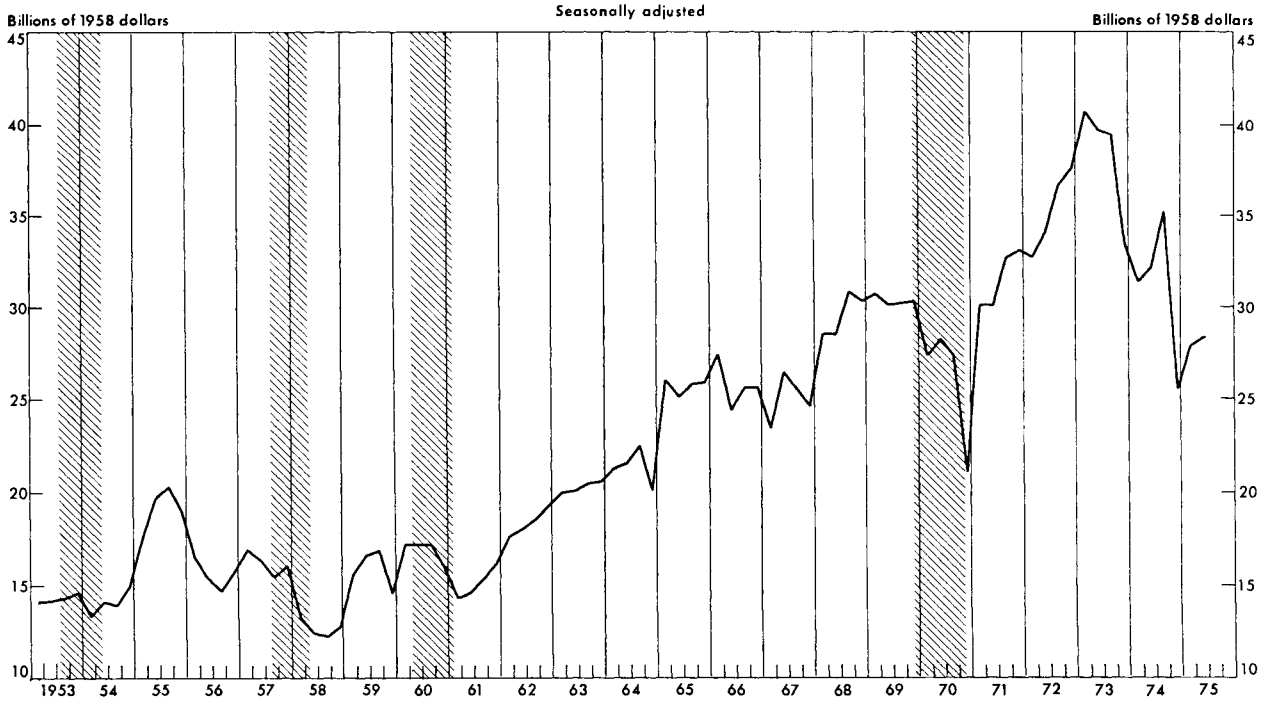
The sharp rebound in automobile sales in recent months is reminiscent of developments in past recovery periods (see Chart I). In the previous postwar cyclical recoveries, real consumer outlays on automobiles have increased, on average, about 37 percent over the twelve months following the trough. Whether new car purchases in the current recovery will fully conform to this historical pattern remains to be seen. Auguring a strengthening in the demand for new cars is the presumably growing need to replace the aging and less efficient stock of existing automobiles. However, the replacement decision is fundamentally an economic one, based on income and employment expectations and on the cost of purchasing and maintaining the car. In the latter regard, the recently announced price hikes on the new 1976 models, coupled with the prospect that the 1977 models will be more economical to operate, might well induce many car owners to postpone purchasing a new car until the 1977 models become available. Judging by their production schedules and tentative forecasts, the automobile manufacturers themselves do not appear to be overly bullish about sales prospects over the remainder of the year. In the event that purchases of the 1976 car models do not increase very much above those of the previous year, thus departing from the pattern of past recoveries, consumers can either save the retained purchasing power or spend it on other goods. Which option they choose will have a significant bearing on the scope of the economic recovery.

The long-awaited upturn in residential construction now appears to be getting under way. Housing starts rose to a seasonally adjusted annual rate of 1.24 million units in July, up 16 percent from the average rate of the second quarter and 41 percent above the low-water mark recorded last December. Whereas virtually all of the recovery in starts earlier in the year had been in single-family units, the July increase was centered in multiple-unit dwellings. Spurred in part by the 5 percent tax credit,

Chart I

CONSUMER EXPENDITURES ON AUTOMOBILES

Seasonally adjusted




Note: Shaded areas represent recession periods, indicated by the National Bureau of Economic Research (NBER) chronology. The latest recession has not yet been dated by the NBER.

Source: United States Department of Commerce, Bureau of Economic Analysis.

sales of new single-family homes by merchant builders have risen substantially in recent months. Although such sales edged down a bit in June, they continued, as had been the case in the previous four months, to exceed the additional new homes put up for sale. As a result, the stock of unsold new single-family homes has receded to the lowest level in three years, and an increasing proportion of this inventory has come to represent homes under construction rather than completed dwellings.

Developments in the mortgage market have played a key role in the recent upturn in home building. The flow of deposits into thrift institutions in the last few months has been heavy, although it is uncertain that the inflow will continue at the recent high pace. In July, the savings flows amounted to a 17.8 percent seasonally adjusted annual rate, about equal to the growth over the first half of the year and almost three times as large as that experienced during the year ended December 1974. While the thrift institutions have, in turn, channeled a large proportion of these funds into securities, they have also been issuing mortgage commitments. Indeed, outstanding mortgage commitments of all savings and loan associations and mutual savings banks in New York State increased at a 63 percent seasonally adjusted annual rate from February to July, whereas they had actually decreased 26 percent over the twelve-month period ended February 1975. Since mortgage commitments must generally be secured before construction financing can be arranged, the recent growth in outstanding commitments suggests that home builders are currently planning to undertake a large number of new construction projects. However, while lending terms for new mortgages eased slightly early in the year, they currently are inching higher. Reflecting this increase in rates on conventional mortgages, the maximum allowable interest charge on Federally insured mortgages was raised at the end of August by ½ percentage point to 9 percent. In addition, at the Federal National Mortgage Association's auction held at the end of August, secondary market interest rates on four-month forward commitments for insured mortgages were 33 basis points above those of the previous month's auction.

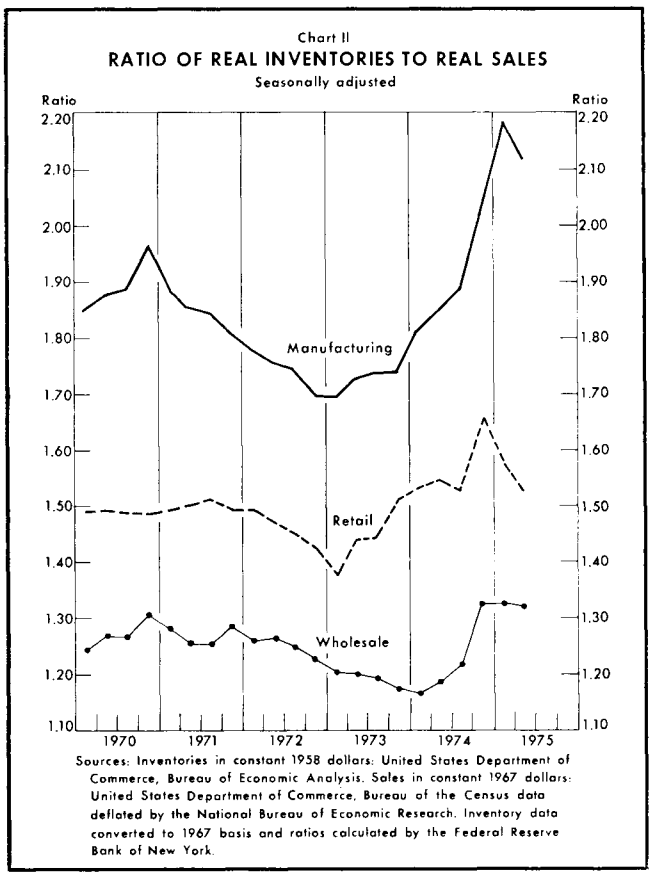
## INDUSTRIAL PRODUCTION, INVENTORIES, AND CAPITAL SPENDING

The Federal Reserve index of industrial production, which had advanced 0.5 percent in June, increased by an equal amount in July, bringing a halt to the 14 percent decline that had been registered between November 1973 and May 1975. Most of this contraction took place between September 1974 and February 1975, as firms throughout the economy struggled to get out from under the huge overhang of excess inventories. Early in 1974, manufacturers had engaged in an all-out effort to rebuild their stockpiles of raw materials and intermediate products, items that had been in extremely short supply at the end of 1973. As this replenishing was going on, however, the aggregate demand for final goods faltered and then plunged. At that point, what had been an inventory shortage suddenly turned into a glut.

This past June, higher output of both consumer goods and nondurable materials finally more than offset continued declines in other sectors. Output of textiles, paper, and chemicals posted sharp rises in June and again in July, suggesting that inventory liquidation may be nearing completion in these industries. On the other hand, further declines in production of most durable materials and of business equipment indicate continued efforts to pare inventories. The iron and steel industry has been especially hard pressed; in July, output of iron and steel declined for the sixth consecutive month to the lowest level since 1971. In retrospect, it appears that the strong demand for steel in 1973 and through most of 1974 had depleted steel-mill inventories. Thus, when the demand by large steel customers dropped, part of the slack in demand was offset by the rebuilding of steel mills' own inventories. By October, however, the mills had restored their inventories of ingots and semifinished shapes, such as rods and wire. Iron and steel production then plummeted, at about double the rate for all other industries. Despite the continuing sluggish demand, several steel companies have announced that, to offset increased production costs, they intend to raise prices in early autumn. As a result, demand for steel has apparently picked up in an effort by mill customers to beat the announced price hikes.

New orders received by durable goods manufacturers spurted in July by $1.7 billion, or 4.3 percent. The July advance was broadly based and marked the fourth consecutive monthly gain. Indeed, the expansion in new durables bookings between March and July amounted to 15 percent, far greater than the growth in production. As a result, the backlog of unfilled durables orders increased in July for the first time since September 1974.

While nonfarm businesses are probably still in the process of liquidating their inventory stocks, the pace appears to be slackening a bit. The reduction of excessive inventories had begun late last year in the wholesale and retail trade sectors, and had spread from there to the nondurables manufacturing sector and then to durables manufacturing. The liquidation in the retail trade sector seems to have diminished considerably. According to recent data on the book value of inventories, retail and



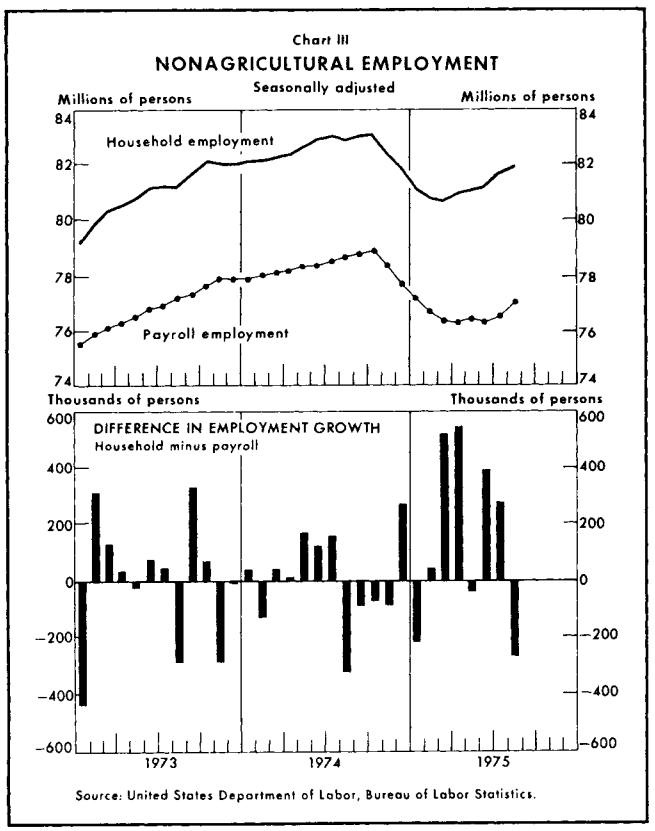

wholesale distributors, apparently encouraged by the rebound in sales, added to their inventories in June for the first time in the current year. Of late, however, the book value data have tended to be a rather unreliable indicator of inventory conditions. The accounting conventions used to value inventories give rise to distorted measurement during periods of inflation, regardless of whether it is a period of accelerating, decelerating, or steady inflation. Hence, to gauge the extent of inventory imbalance it is more useful at the present time to examine ratios of real inventories (i.e., inventories valued in constant dollars rather than book value) to real sales (see Chart II). Within the retail trade sector, the real inventory-sales ratio had backed off considerably by the second quarter of this year from the peak attained in the last quarter of 1974. On the other hand, hardly any improvement occurred in the real inventory-sales ratio for the wholesale trade sector, with the level in the second quarter just about equal to the cyclical peak. Moreover, substantial inventory imbalances continue to exist in manufacturing; inventories relative to sales fell only slightly in the second quarter after having reached exceedingly high levels earlier in the year. Monthly data on the book value of manufacturers' inventories indicate that the liquidation continued in July. Manufacturing inventories fell that month at an annual rate of $11.4 billion, with the bulk of the decline in the durable goods sector. Moreover, the August survey by the National Association of Purchasing Management indicates a further runoff in the stocks of purchased materials.

According to the Commerce Department survey taken in July and August, businessmen again lowered their planned expenditures on new plant and equipment. Capital outlays over the second half of 1975 now are projected to rise at an annual rate of only 1.9 percent. The weakening outlook for capital spending is also reflected in capital appropriations. As reported by the Conference Board's survey of large manufacturers, capital appropriations were slashed by 17.7 percent in the second quarter, marking the third consecutive quarterly decline and the largest cutback on record. While most manufacturers continued to reduce appropriations, automobile manufacturers raised the level of their appropriations by about 40 percent. This reflected the large retooling expenses associated with the changeover to the 1977 models.

## LABOR MARKET DEVELOPMENTS

The labor market showed signs of strengthening in August. Based on the household survey conducted by the Department of Labor, employment rose by 274,000 workers on a seasonally adjusted basis. With the civilian labor force growing by a comparable magnitude, the overall rate of joblessness remained unchanged at July's level of 8.4 percent. Over the five months ended August, the household survey has recorded an increase in nonagricultural employment of 1.3 million (see top portion of Chart III). However, the survey of establishments, the so-called payroll survey, shows a much less favorable employment situation, with an advance of only 667,000 workers. While month-to-month divergences between the two series are not infrequent, these divergences tend to be offsetting over longer periods (see bottom portion of Chart III). The large August gain of 528,000 workers in payroll employment helped reduce the discrepancy that had developed since March between the increases indicated by the two series. The percentage of industries recording employment increases rose above 70 percent, to the highest level since late 1973, underscoring the August pickup in payroll employment.

The divergent behavior in recent months of the two nonfarm employment series reflects, in part, differences in sample coverage. The household survey measures the number of persons holding jobs, while the payroll survey seeks to gauge the number of filled job slots. For example, a person holding two jobs would be counted twice in the payroll survey but only once in the household survey. Nevertheless, measured household employment is always greater than payroll employment, since the coverage of the household survey is more comprehensive. While both surveys count employed wage and salary workers, the household survey includes the self-employed, certain unpaid workers of family-operated enterprises, and private household workers, none of whom appear on establishment payrolls. Also, unlike the payroll count, the household survey includes unpaid absences associated with illness, bad weather, strikes, vacation, and other personal reasons. Although there are also other differences in coverage, the above discrepancies are usually responsible for most of the divergent monthly behavior of the two series. However, only some of these elements of disparate coverage can be readily quantified with published seasonally adjusted monthly data. In recent months, the measurable sources of disparity have fallen far short of accounting for the divergent movements in the two series.




Some of the remaining unexplained discrepancies between the two surveys arise from differences in sampling techniques and in collection and estimation methods. The household survey is gathered from a scientifically selected sample of about 50,000 households during the week that includes the twelfth of the month. The establishment survey, reflecting the payroll period that also includes the twelfth of the month, is based upon payroll reports from a sample of firms employing over 30 million wage and salary workers, roughly 40 percent of the estimated total number of workers on establishment payrolls. The large size of the payroll sample reduces sampling variability and results in a more stable monthly data series. Although both series are subject to similar seasonal fluctuations, the monthly patterns of the seasonal adjustment factors do differ somewhat and may contribute significantly to the disparity between the series. In addition, there are also other methodological details that can contribute to divergent monthly behavior of the two surveys.

During periods in which these major surveys are giving different signals, it is important to look at movements in other labor market indicators. Data on labor turnover rates in manufacturing, which are available only through July, suggest some improvement in the labor market. In July there was a jump in the rate at which new workers have been hired, marking the fourth consecutive monthly increase. At the same time, the layoff rate—the number of workers laid off in a month per 100 employees—fell to the lowest level since late 1974. Improving employment prospects are also reflected in the increase in the number of individuals voluntarily leaving their present jobs; in July, such quits exceeded the layoff rate for the first time since October. A gauge of the demand for labor in all industries is provided by the Conference Board's index of the volume of newspaper help-wanted advertising. While still low by historical standards, this index rose in July to its highest level in seven months.

## THE PRICE SITUATION

Rapid inflation erupted again in July and August, propelled by a bulge in energy and food prices. Outside these troublesome sectors, price increases remained relatively moderate. But the near-term outlook for an easing of inflation is not very encouraging. Significant increases will probably occur soon for some foods and for oil, aluminum, steel, and automobiles.

After moderating for several months, consumer prices jumped sharply in June and July. In the latter month, the consumer price index rose 1.2 percent, the sharpest rate of increase in ten months. Food prices, led by price hikes on meat and poultry, surged. Consumer energy prices, primarily on gasoline and motor oil, also rose at extremely rapid rates. Excluding energy prices, nonfood commodity prices rose 0.6 percent. However, the announced increases in auto prices will soon be felt. There could be additional shocks to the consumer price index in the near future as a result of higher energy prices. This would occur if members of the Organization of Petroleum Exporting Countries increase their oil prices this fall. Although the legislation authorizing controls on prices of domestically produced "old" oil lapsed at the end of August, no sharp price increases have been posted—perhaps reflecting expectations of the imminent reimposition of controls for a temporary period. Prices would be expected to rise, however, if a program of gradual decontrol were to be enacted. Such a program might well be accompanied by an excess profits tax on oil companies and by tax credits to consumers to offset, at least partially, the impact of higher prices. In these circumstances, the resulting increase in the consumer price index would exaggerate the inflationary impact on consumers, since fuel costs are a direct component of the consumer price index whereas taxes (and tax credits) are not.

At the wholesale level, prices rose in August at a 0.8 percent seasonally adjusted rate. Prices of fuel and power continued to accelerate, increasing at a rate of about 3 percent; part of this upsurge probably reflects the recently enacted import fees on crude oil and refined petroleum products. Industrial commodity prices other than power and fuel rose 0.3 percent. Over the six months ended August, these prices have risen at an annual rate of only 1.5 percent. Prices of farm products and processed foods and feeds declined nearly 1 percent in August, after having jumped the month earlier. This turnaround was led by prices of fresh meats and vegetables.

Over the four weeks ended August 26, the Bureau of Labor Statistics index of basic commodities jumped 3.5 percent. Industrial commodity prices rose 6.9 percent, as prices surged in mid-August, led by price increases for lead and steel scrap. It is possible, however, that to a large extent the advances in these metal prices was the result of buyers hedging against higher future mill prices. Thus, it need not be expected that these prices will continue to shoot up. Prices of raw foodstuffs have edged down in recent weeks. Improved growing conditions have raised prospects for corn and wheat production, although concern over increased foreign demand for United States exports remains. The latest Department of Agriculture estimates now suggest that carry-over stocks of these key crops may increase only slightly.

# The Business Situation

The pace of the economic recovery seems to have picked up a bit in recent months, but the upward thrust is still coming from only a few sectors of the economy. In August, large and broadly based gains were registered in industrial production, employment, new durables orders, and personal income. In September, moreover, there was a healthy advance in payroll employment and the overall unemployment rate inched down to 8.3 percent. On the other hand, retail sales posted an outright decline in August, while automotive sales have been sluggish since July. In any event, it appears that the stepped-up rates of production and employment in August were outgrowths primarily of reduced inventory liquidation. Elsewhere in the economy, there were some tentative signs of further strengthening. The modest recovery in residential construction is continuing, as housing starts advanced further. In addition, production of business equipment moved ahead in the month. However, capital spending levels seem likely to remain depressed until there is less idle capacity in the economy.

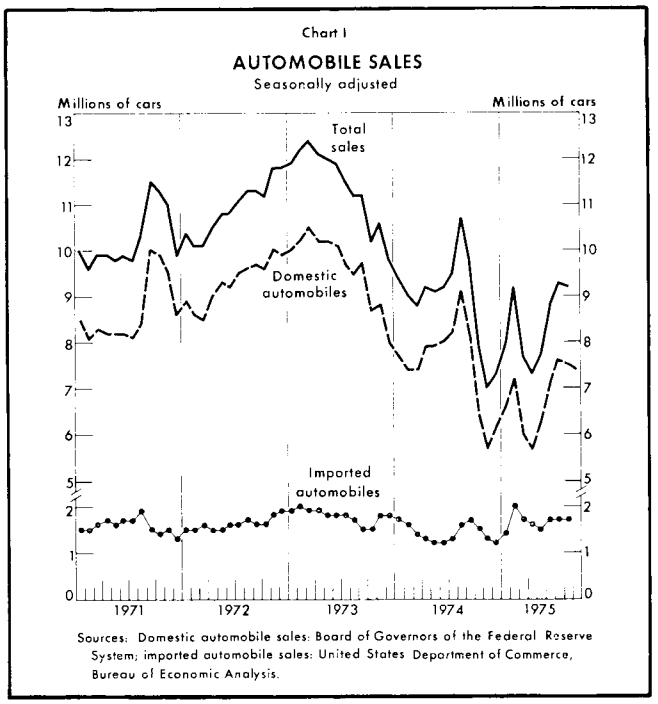
Of late, the erratic monthly movements in the price data have made it unusually difficult to analyze the underlying inflationary situation. This irregular pattern has in part reflected the abrupt spurts and halts in the prices of energy and food. However, it does appear that nonfood, nonenergy prices have been rising at a somewhat faster clip recently than they had in earlier months of the year. This suggests that, while the slowdown in inflation in the current year has been considerable, it had been overstated as some of the earlier data had been heavily but temporarily influenced by the determined efforts of businesses to eliminate their inventory overhangs.

Looking ahead, increases in food and oil prices are likely to play a major role in determining the near-term situation. Among the factors shaping the near-term outlook for food prices are the extent of world demand for United States crops, including the Soviet grain purchases, and the continued adjustments in the livestock feed sector of the agricultural economy. The $1.05 per barrel hike in the price of crude oil instituted by the Organization of Petroleum Exporting Countries (OPEC) at the beginning of October may provide a modest temporary boost in inflation. Also, while price controls on domestically produced oil have been extended through mid-November, the cost of domestic oil to oil refiners will rise further if these controls are lifted, with the timing of the impact of course depending upon whether decontrol is sudden or gradual. It should be noted, nevertheless, that the inflationary impact of these prospective increases in food and oil prices will almost surely be much smaller than those increases which occurred and contributed to the inordinately rapid inflation in 1973 and 1974.

## PERSONAL INCOME, CONSUMER SPENDING, AND RESIDENTIAL CONSTRUCTION

Propelled by a record expansion of factory payrolls, personal income jumped by 1.5 percent in August. Wage and salary disbursements shot ahead at an $11.6 billion annual rate, compared with an average increase of $2.2 billion in the first seven months of 1975. Almost half of the August increase was in manufacturing payrolls, which had also shown a healthy rise in the previous month. Transfer payments rose at a $2 billion annual rate, following a large drop in July caused by the sizable one-shot June payment to Federal Government pension recipients. In the first three months of 1975, increases in transfer payments exerted an important stabilizing influence on personal income, as wage and salary disbursements remained below their December 1974 level. Since March, however, increases in wage and salary income have been the mainstay of the revival in personal income, with wage and salary disbursements increasing almost three times as much as transfer payments.

Although retail sales declined in August, they had been advancing strongly. From March to July, total sales grew at a 26.3 percent annual rate, almost quadruple the rise in consumer prices. In the four months ended in July, more than 40 percent of the increase in retail sales was attributable to a rebound in automotive sales. Since July,




however, auto sales have been essentially flat. Sales of domestic models in September were 7.4 million units at a seasonally adjusted annual rate, slightly below the levels recorded in July and August (see Chart I). It remains to be seen to what extent a prospective rebound in automobile sales will follow the typically strong pattern of past recoveries.

Housing starts edged up to 1.26 million units at an annual rate in August. However, permits slipped below the 1 million unit annual-rate mark, though they were still above the levels recorded from August 1974 through the first six months of this year. Thus far, the moderate housing recovery which began in May has been concentrated primarily in single-family units, as multifamily starts have remained at very low levels. The inventory of unsold homes in July rose to 8.8 months of sales, the highest level in four months but still below any reading in the 21-month period ended in March 1975.

To some extent, further recovery in housing may well be limited by the recent run-up in interest rates. Steep mortgage interest costs discourage potential home buyers. At the same time, savings flows to thrift institutions are restrained by higher rates on competing financial instruments. Thrift institutions are, of course, a major source of funds to the housing market, but their deposit rates are constrained by the legally set ceilings.

## INDUSTRIAL PRODUCTION, INVENTORIES, AND CAPITAL SPENDING

During August, the Federal Reserve Board's index of industrial production registered a 1.3 percent increase, marking the fourth consecutive monthly increase and the largest advance since October 1972 (see Chart II). The August rise was broadly based across both industry categories and market groupings. Iron and steel production rose for the first time since January of this year. In part, the latter pickup may reflect attempts by steel mill customers to "bunch" purchases prior to the price hikes announced by steel companies for this autumn. Nondurable goods output moved ahead strongly once again, following sizable gains in the previous four months. Across market groupings, production of consumer goods in both the durables and nondurables categories continued a pattern of steady increases. Business equipment output posted a sizable advance in August, following ten months of uninterrupted declines. Production of materials advanced for the third straight month after falling without interruption since September 1974. This movement provides some support for the view that the paring of inventories which has been going on throughout the current year is moderating.

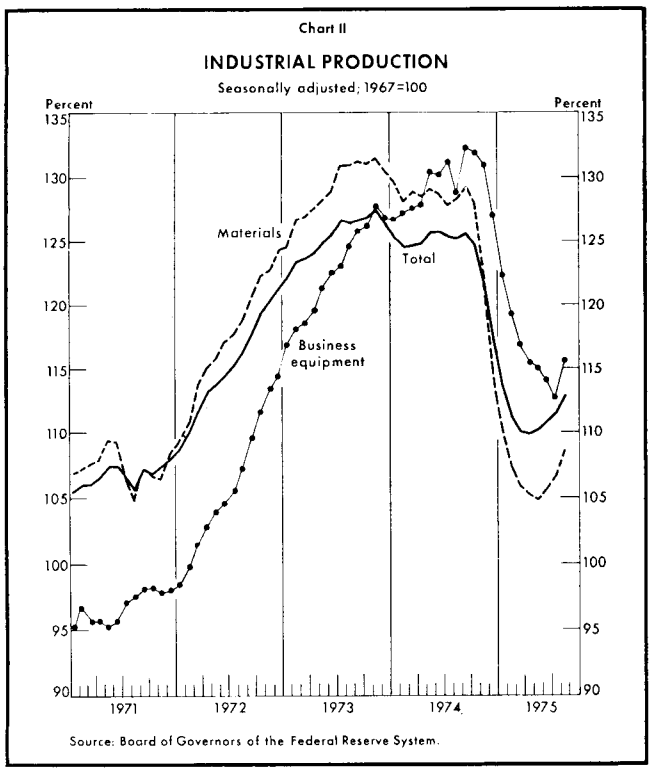
New orders for durable goods manufacturers moved ahead by $0.9 billion or 2.1 percent in August, marking the fifth consecutive monthly increase. The rise in bookings since March has exceeded production growth by a wide margin. As a result, the backlog of unfilled orders posted its second straight monthly advance.

Businesses are still trimming their inventories on balance, but the cutbacks have eased considerably in recent months. Book value inventories in the retail trade sector advanced for the second straight month in July, following declines in book value in the first five months of the year. At wholesale outlets, book value inventories registered a decline in July, after increasing in June and falling in the previous five months. The book value of manufacturing inventories fell in August, the sixth consecutive month of decline. Unlike past months, however, all of the August reduction was concentrated within the durables manufacturing sector.

In inflationary periods, book value data tend to give a distorted picture of the inflationary situation. However, the most recent monthly movements in book value inventories are consistent with the pattern of the ratios of real inventories to real sales in the first half of 1975. Real

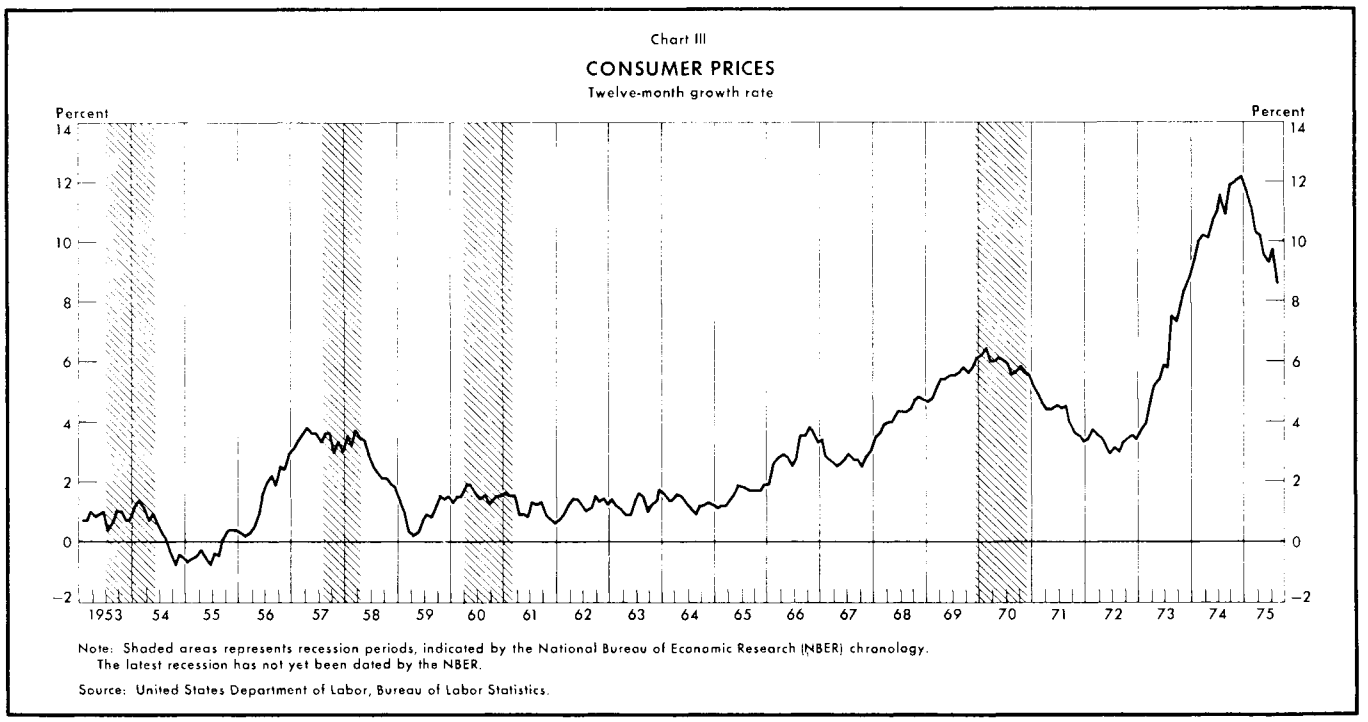
inventory figures for these sectors are available on a quarterly basis through the first half of this year. In the retail trade sector, the real inventory-sales ratio moved down considerably in the first half of the year from the peak attained in the fourth quarter of 1974. When combined with positive book value accumulation in June and July, these data suggest that inventory paring in the retail sector is over. In the wholesale trade sector, the real inventory-sales ratio hardly retreated at all during the first two quarters of this year from its late-1974 peak. Therefore, it is probable that the inventory correction in the wholesale trade sector has not yet been completed, although it has lately been proceeding at a substantially reduced rate. In the manufacturing sector, the ratio of real inventories to real sales had backed off only slightly in the second quarter from the exceedingly high first-quarter level. Thus, the latest monthly book value data suggest that the process of liquidation is continuing unabated for durables manufacturers but has diminished substantially for nondurables manufacturers.

Recent surveys point to continuing declines in the level of real capital spending. The Commerce Department survey of planned plant and equipment outlays taken in July and August showed a projected rise in nominal capital outlays over the second half of 1975 of only 1.9 percent at an annual rate. If this increase in nominal capital outlays is realized, it will mean a further drop in the level of real capital spending over the remainder of the year. In addition, a recent survey by Lionel D. Edie & Company projects an increase in nominal capital spending of only 5 percent for all of 1976. The latter survey probably implies a further reduction in the real capital spending level next year. In previous business cycles during the postwar period, troughs in real capital spending either have been coincident with troughs in industrial production or have lagged the industrial production trough by one quarter. The most recent contraction in industrial production bottomed out in April. Hence, if real capital outlays do in fact fall further in 1976, there would be a significantly more sluggish response for investment than has occurred in past business-cycle upturns. Unquestionably, the course of capital spending will depend on the overall pace of economic recovery, particularly in the crucial consumer spending sector. However, real capital spending is not likely to expand vigorously until there are less slack and idle capacity in the economy.




## LABOR MARKET DEVELOPMENTS

Although the evidence is somewhat mixed, it appears that labor market conditions showed some further signs of strengthening in September. According to the payroll survey of establishments, seasonally adjusted payroll employment expanded by 182,000 workers in September, on the heels of the large 350,000 advance in August. The entire September increase was attributable to higher payrolls in the manufacturing sector, while other sectors were little changed on balance. Manufacturing payrolls had shown a similar gain in the previous month and have accounted for almost two thirds of the payroll gains since July. In the separate survey of households, labor market conditions were essentially unchanged as nonagricultural employment edged down slightly in the month. Nevertheless, the civilian unemployment rate fell to 8.3 percent of the labor force, down from 8.4 percent in July and August. Large gains in payroll employment in the two most recent months have helped reduce the discrepancy that had developed since March between the recorded increases in employment in the two surveys. While such divergences are not uncommon on a monthly basis, they do tend to be close to zero over longer periods. On the other hand, the increases in the unemployment rate for adult males as well as in the number of job losers were disquieting signs of




weakness in the September household survey.

The pace of wage-rate increases in the private nonfarm economy has remained moderate in recent months. Since movements in the average hourly earnings series reflect not only wage-rate changes but also changes in manufacturing overtime and interindustry shifts in employment, a better measure of wage-rate changes is the adjusted hourly earnings index. Adjusted for changes in overtime in manufacturing and interindustry employment shifts, average hourly earnings in the private nonfarm economy advanced at a 6.0 percent annual rate between July and September. This recent rate of gain compares favorably with increases of 8.0 and 6.9 percent posted in the first and second quarters of this year, respectively.

## PRICES

Lately there has been a good deal of uncertainty and uneasiness over the near-term inflationary outlook. Indeed, the sudden flare-up in the rate of inflation in the midsummer months at both the wholesale and retail levels prompted concern that a resurgence in inflation was in the offing. Moreover, the recent oil price hike by the OPEC cartel, the possibility of some form of domestic oil price decontrol before the end of the year, and the Soviet grain sales have added to the worry about the price outlook. However, several considerations suggest that a return to the inordinately high rates of inflation experienced in 1974 is not likely. On the one hand, such an eventuality at the current stage of the business cycle would be a marked departure from past experience. During the first year of recovery in the past four postwar recessions, the growth of consumer prices did not accelerate from the rates experienced during the latter part of the recessions (see Chart III). In addition, analysis of the special factors relating to food and energy suggests that any acceleration in inflation coming from these sources is likely to be much more modest than last year's experience.

Following the acceleration in consumer prices in June and July, the consumer price index inched up a mere 0.2 percent in August, the slowest rate of advance this year. Food prices were unchanged in the month, reflecting offsetting increases and decreases for various food categories. Prices of meats, poultry, and fish registered sizable increases, while prices of fruits, vegetables, cereals, and bakery products fell. Nonfood commodity prices posted a moderate rise, following a rapid increase in the previous

month which was spurred by gains in consumer energy prices. Prices of consumer services also registered a bit smaller gain.

Wholesale prices rose at a 0.6 percent seasonally adjusted rate in September. Fuel and power prices moved ahead at about a 1.6 percent rate, only slightly below the average rate of increase posted over the three previous months. Excluding the fuel and power component, industrial commodity prices rose about 0.6 percent. The latest advance for nonfuel industrial commodities was well above gains in the previous six months and marked the fifth consecutive month of accelerating price increases. In part, the relatively moderate price increases posted from March through August may have reflected the elimination by firms of a substantial inventory overhang. Prices of farm products and processed foods and feeds jumped 2.3 percent after having fallen nearly 1 percent in the previous month. The increase was paced by higher prices for hogs, cattle, wheat, milk, and eggs.

Were it not for questions about the food and energy areas, the near-term outlook for inflation would almost surely have entailed rates of inflation well below the double-digit range. The sharp run-up in inflation during 1973 and 1974 can be traced, in large part, to exceptional factors, such as depreciation of the United States dollar in the foreign exchange markets, the termination of wage and price controls, the quadrupling of foreign oil prices, and worldwide crop failures. Most of these factors have now run their course and have had their full impact on inflation. In addition, in early stages of past recoveries, the excess capacity and slack within the economy have tended to restrain the rate of growth of prices. In the current recovery, however, it does seem as though consumer prices outside the food and energy areas have lately tended to rise at somewhat faster rates than those experienced earlier in the year, despite the pronounced slack. Considering the unusually heavy inventory liquidation that was occurring at that time, perhaps businesses were temporarily keeping a very tight lid on price increases until they had managed to eliminate the inventory overhangs. In that event, the rates of inflation recorded earlier in the year would have been below the levels consistent with the underlying cost trends. This would explain the current anomalous situation in which nonfood, nonenergy prices appear to be accelerating somewhat in the face of the high unemployment rate and low rates of capacity utilization.

The July sale of 9.8 million tons of grain to the Soviet Union plus possible Government approval of further sales later this year has triggered fears of food inflation similar to that experienced after the 1972 Soviet purchases. However, the overall agricultural situation is quite different from 1972 when in addition to the Soviet purchases there were poor crops here and abroad, a sharp cutback in the output of Peruvian fish meal, and a burst in agricultural exports. The wheat harvest this year is a record, while the corn crop recovered sharply from last year's disappointing performance. Therefore, before the Soviet grain sales, there had seemed to be a good chance that food price rises would moderate markedly from those recorded in the past few years. Since then, however, the United States Department of Agriculture has estimated that already consummated export sales might add 1.5 percentage points to retail food inflation in 1976. The impact of such a rise in the price of food, which constitutes around one fourth of the total consumer price index, on overall consumer price inflation would amount to less than 0.5 percent. With respect to the timing of the increase, higher wheat prices could put pressure on retail prices for cereal and bakery products in coming months. Higher corn prices could raise feed costs and stimulate the slaughter of beef. In that event, meat price increases would temporarily moderate, followed by some reacceleration when beef supplies tighten in early 1976.

Presently, it is far from certain that energy prices will experience any sustained rapid rise. The recent OPEC decision to raise foreign oil prices by 10 percent or $1.05 per barrel, effective October 1, is a far cry from the approximately $7 run-up that occurred in late 1973 and early 1974 when energy prices soared in response. In addition, the impact of the most recent OPEC price hike on domestic oil prices may be blunted to some extent by price shading by some members of OPEC. Furthermore, in view of the recent weak domestic demand for some refined oil products, it is unclear how much and how fast the increase in crude oil prices will be passed along to consumers. Of course, a good deal of uncertainty also exists about the exact nature of possible domestic oil price decontrol after the recently extended November 15 termination of controls. Sudden decontrol would concentrate the price impact over a short time span, while phased decontrol would spread the impact over a longer period. In the event that the $2 duty on imported oil is removed, some of the impact from the OPEC oil price rise and the possible termination of controls would be offset. Clearly then, the outcome with respect to domestic price controls and tariffs is one of the major uncertainties of the near-term inflation outlook.

# The Business Situation

Economic activity has advanced sharply in recent months, but the upward impetus is still rather narrowly based. In the third quarter, the increment in gross national product (GNP) in real terms was the largest in twenty years. Over half of this gain, however, was attributable to the marked slowdown in the rate of inventory liquidation. Expansion in consumption spending, especially on durable goods, accounted for the rest of the increase. Elsewhere, there was barely any movement, as the small increases and decreases recorded for the other components of real aggregate demand were largely offsetting. Nor are there any clear-cut signals of developing strength in these other spending components. Looking ahead, once the inventory imbalance has been eliminated, it appears that the pace of the economic recovery will for a time be keyed closely to the growth in consumption spending.

While there continues to be a good deal of variability in the monthly price data, the overall rate of inflation was about 7 percent at an annual rate in the third quarter. This is a bit higher than the rate of inflation in the previous quarter but is still a substantial improvement over the double-digit increases recorded last year. However, the acceleration of wholesale industrial commodity prices in the past six months, together with the flare-up of these prices in October, is a worrisome development which suggests that the prospects for a significant slowdown in the near term are anything but certain. Whereas the huge overhang of inventories had fostered some moderation in price increases earlier in the year, this imbalance has been largely eliminated. Moreover, after having tapered off a bit, the rate of growth of wages appears to have quickened somewhat in recent months, and fuel and energy prices have been rising at a slightly faster pace.

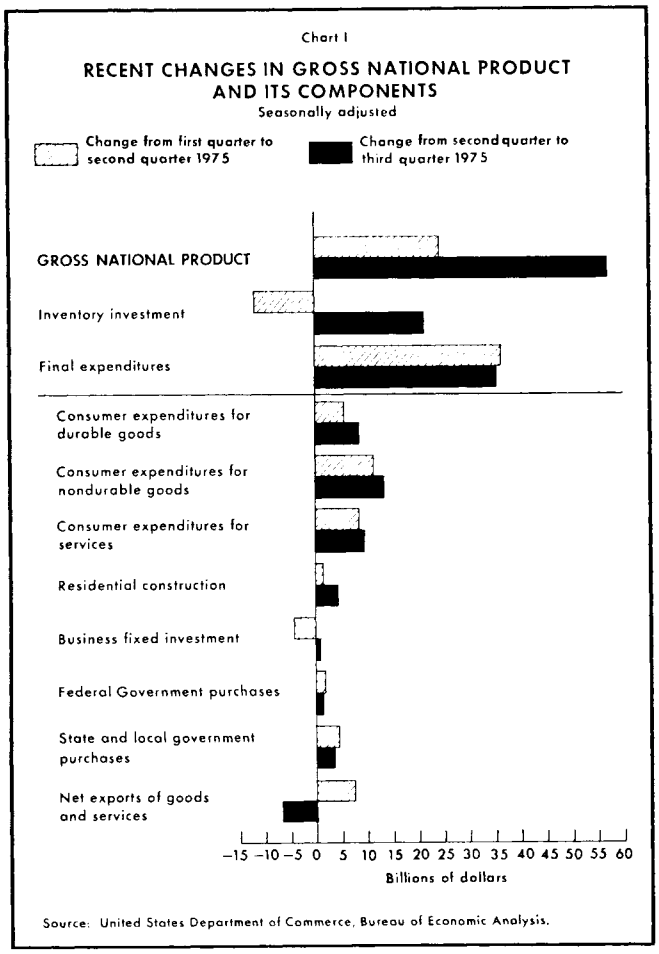
## GNP AND RELATED DEVELOPMENTS

According to preliminary estimates compiled by the Department of Commerce, the market value of the nation's output of goods and services (GNP) rose in the third quarter at a 16.8 percent annual rate of increase. Measured in terms of 1958 prices to correct for changes in the price level, the increment in real GNP amounted to a hefty 11.2 percent rate, up from the 1.9 percent rise of the previous quarter and the biggest quarterly gain in twenty years. Nevertheless, real GNP was still almost 5 percent below the peak recorded at the end of 1973.

Contributing most to the third-quarter surge in GNP was the sharp slowdown in the pace of inventory liquidation (see Chart I). Indeed, the slower runoff of business inventories accounted for more than half of the total gain in real GNP. In fact, the monthly data on the book value of business inventories (which are, however, measured differently than in the national income accounts) showed a sizable accumulation occurring in August for the first time since last January. Moreover, the August increase was broadly distributed throughout the trade and manufacturing sectors, the only exception being in the durables manufacturing industries. This pattern suggests that much of the inventory overhang has now been eliminated. Further corroborating evidence can be gleaned from the recent behavior of the ratio of real nonfarm business inventories to real final sales of the business sector. This ratio jumped to a record peak at the end of 1974; since then, it has declined steadily to about the level of the first half of last year. While imbalances still exist within certain segments of the economy, notably the durables manufacturing sector, it does look as though the inventory liquidation process will have run its course in the next few months. Once the inventory correction has been completed, the speed of the economic recovery will then be paced by the strength in real final sales.

In the third quarter, final expenditures—equal to GNP less the change in business inventories—moved ahead at a 4.4 percent annual rate in real terms, just about equal to the growth of the previous quarter. The sizable advance in consumption spending more than accounted for the increase in real final sales. Among the other components of aggregate demand, there were small increases and decreases which were largely offsetting, on balance.

Buoyed by the vigorous economic recovery, the one-shot 1974 tax rebates, the special payments to recipients of social security, and the 1975 tax reductions, disposable personal income has staged a fairly strong comeback since




the beginning of the year in real terms. As of the first quarter, real disposable income had fallen 4.1 percent below the peak attained at the end of 1973, by far the largest postwar cyclical decline on record. Since then, real disposable income has rebounded sharply, though only half the real loss has been recouped.

In retrospect, the decline in real disposable income over the last two years appears to have been distributed unevenly among workers. Much of the decline can be attributed to the effects of the recession on employment, including the unusually sharp rise in the proportion of part-time to total employment, rather than a drop in the real wages of those full-time workers who have remained employed. Indeed, there has been some confusion over this point. Compounding the confusion is the fact that, according to data collected by the Bureau of Labor Statistics in its payroll survey, average weekly earnings have risen at a slower rate than the consumer price index since 1973 (see Chart II, but note that these are annual observations recorded as of May in each year). In large part, however, the erosion in this measure of the real wage has stemmed from compositional changes within the employed work force. First, while there had long been an uptrend in the proportion of part-time to total employment, the recently ended recession exacerbated this trend greatly, as many formerly full-time workers had to settle for part-time employment along with a sharp cutback in their weekly earnings. Second, for many years including the last few, the full-time work force has been composed of proportionately more women and young workers, both of whom tend to earn less than their adult male counterparts. Adjusted for changes in the age-sex composition, it turns out that the average weekly earnings of full-time workers, after accounting for the effect of inflation, fell only 4 percent between 1973 and 1975 (see Chart II). This was about half of the decline experienced by average weekly earnings in real terms, as measured by the establishment survey. It should be mentioned, however, that these estimates of weekly earnings are measured on a before-tax basis and, therefore, do not take into account the effect of inflation on workers' aftertax earnings. That is, even if consumer prices and before-tax wages do grow at the same rate, the progressivity of the personal income tax structure implies that workers will still experience a reduction in their real aftertax earnings. To some extent, of course, the legislated decreases in the 1975 personal income tax rates have partly offset this effect.

Spurred by the continuation of the recent gains in disposable income, real consumption spending advanced at a 7 percent annual rate in the third quarter, a shade higher than that of the preceding quarter. Consumption outlays have been the dominant factor in the current economic recovery. Since the opening quarter of the year, the expansion in real consumption expenditures has accounted for over two thirds of the total increment in real GNP. Even more importantly, the pickup in consumption has facilitated the liquidation of the huge overhang of inventories.

Consumer outlays on durables advanced briskly in the third quarter. Historically, no doubt because these purchases are postponable and often involve replacements, real consumption spending on durables has tended to move in a pronounced procyclical fashion (see Chart III). In recessions, the largest cutbacks in consumption spending occur in purchases of durable goods. In turn, during the ensuing recoveries, real durables outlays snap back vigorously. Indeed, in the four previous cyclical recoveries, the expansion in real consumption durables sales has averaged a bit more than 20 percent in the four quarters after the cyclical trough. The official date of the trough of the

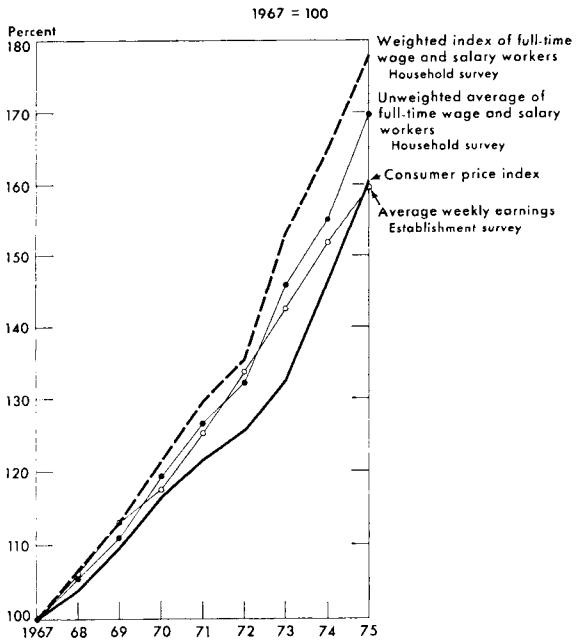
most recent recession has not yet been posted by the National Bureau of Economic Research, but it will probably be located in the second quarter since that is when industrial production bottomed out. Hence, given this tentative dating, the current resurgence in real consumer durables spending has to date surpassed those experienced in all previous postwar upturns, except for the 1970-71 recovery which was bolstered by the aftermath of the General Motors strike during the last quarter of 1970. Whether this rapid pace will be sustained in the months to come remains to be seen. Indeed, although the average level of domestic automobile sales in the third quarter was well above that of the preceding three months, the monthly sales pattern has been fairly flat from July to October.

In real terms, residential construction outlays posted a healthy advance in the third quarter, following a minuscule rise in the previous quarter and the precipitous two-year slide before that. The third-quarter increase in real residential construction outlays reflected a higher level of housing starts, compared with the level of the previous quarter.

Chart II

ALTERNATIVE MEASURES OF GROSS WEEKLY EARNINGS

1967 = 100




Notes: Data are for May of each year shown and are not seasonally adjusted. The 1968 data points for the two household series are interpolations of the preceding and following years. The weighted index measure uses fixed 1967 relative employment weights for the earnings of different age-sex groups.

Sources: United States Department of Labor, Bureau of Labor Statistics. The weighted index was calculated by the staff of the Federal Reserve Bank of New York.

Housing starts were running at a 1.25 million unit annual rate in the July-September period, up from the 1 million unit rate averaged in the first half of the year. However, housing starts in September, the most recent month for which data are available, were essentially unchanged from the July level. In the third quarter, mortgage interest rates, which had been at very high levels by historical standards, edged up further. The average yield on Federal National Mortgage Association home-mortgage commitments rose about 80 basis points from the end of June to the end of September, although it declined about 20 basis points in October. While the high rates currently prevailing on home mortgages make them an attractive investment from the viewpoint of thrift institutions, they do tend to discourage potential home buyers from undertaking such long-range commitments. In addition to high mortgage costs, prospective homeowners may be concerned about the rapid run-up in the prices of fuels and utilities.

In the third quarter, business fixed investment spending was virtually unchanged in real terms from what it had been in the April-June period. This leveling off marks the end of a steep year-long contraction in real outlays on plant and equipment, which left these expenditures about 17 percent below what they had been a year previously. It is interesting to note that, in past cyclical recoveries, a turnabout in real outlays on plant and equipment has occurred either in the same quarter or one quarter after the business-cycle trough.

It remains to be seen, however, whether the pattern of real capital spending in the current recovery will turn out to be consistent with historical experience. To some extent, businesses may lately have boosted their capital spending in response to the temporary increase in the investment tax credit. This increase is due to lapse at the end of the year. Even if extended, however, the higher investment tax credit is not likely to exert much additional stimulus to capital spending, unless business conditions continue to improve in other respects. Indeed, capital spending within the key manufacturing sector remains weak, judging by the recent behavior of net new capital appropriations by the nation's 1,000 largest manufacturers. On a seasonally adjusted basis, net new appropriations have declined steadily from the peak of $15.9 billion recorded in the third quarter of 1974 to $8.8 billion in the second quarter of this year, the latest period for which data are available. In view of the significant lags separating appropriations, orders, and actual expenditures, the recent drop in net new appropriations has probably not yet had its full depressive effect on manufacturers' actual outlays on plant and equipment. Nevertheless, there seems to be a rather large backlog of unspent


appropriations, suggesting that firms have lately been postponing projects rather than canceling them. Hence, if there were a pickup in the pace of real final sales, this would be an incentive for businesses to decide to go ahead with their postponed projects. The rundown in the backlog of unspent appropriations would impart added momentum to investment spending but probably not before the end of the year.

Net exports declined in the third quarter in both nominal and real terms, as imports of goods and services posted a larger advance than exports. Modest increases in this spending component in three previous quarters had acted as a stabilizing influence, albeit a minor one, just as it has in most postwar recessions.

## PRICE SITUATION

Although erratic monthly movements in the recent price data have made their interpretation difficult, it nevertheless appears that the overall annual rate of inflation in the third quarter was about 7 percent. As measured by the GNP implicit deflator, prices of goods and services advanced at a 5 percent annual rate. However, the fixed-weight GNP price index, which is unaffected by compositional shifts in output, rose at a 7.2 percent seasonally adjusted annual rate, compared with 5.5 percent in the second quarter. In the previous postwar recoveries, price increases generally continued to moderate in the period immediately following the trough in industrial production. Hence, at this early point in the recovery, a significant acceleration in inflation would be an unusual and unlikely occurrence. Yet any further slowdown in the rate of inflation will be severely constrained by the underlying pressure from wages and materials costs.

Consumer prices rose at an 8.2 percent seasonally adjusted annual rate in the third quarter, up from the 5.8 percent advance in the previous quarter. Food prices increased at an 11.8 percent annual rate, mostly because of the large spurt in July. Similarly, nonfood commodity prices climbed at a 7.2 percent annual rate, also reflecting a July spurt and much more moderate advances in the last two months of the quarter. Prices of services exhibited modest gains through the months of the third quarter except in September when the large gain posted was primarily the result of the subway fare increase in New York City. Thus, while the third quarter's rate of price inflation was higher than the previous quarter, price gains tended to be moderate in the last two months of the quarter. In part, the midsummer flare-up in nonfood prices may have reflected an unsustainable slowing of price increases in the last months of the second quarter as firms were attempting to get out from under the very substantial inventory overhang.

At the wholesale level, there was a resurgence in inflation in October, following the very moderate advance in the previous month. The October run-up in wholesale industrial prices amounted to a rapid 14.4 percent annual rate and was paced by large price increases for milled steel products, new passenger cars, textiles and apparels, and lumber and wood products. Including the October spurt, wholesale industrial prices have steadily accelerated over the past six months. While this pattern probably in part reflects the unsustainably low price increases recorded in the second quarter, when so many firms were doggedly trying to get out from under the massive overhang of inventories, the prolonged upward thrust in the rate of inflation in wholesale prices is a rather worrisome development. Also, the wholesale prices of farm products and of processed foods and feeds posted a rather big increase in October, moving ahead at about a 20 percent annual rate.

## WAGES, PRODUCTIVITY, AND EMPLOYMENT

Recent data indicate that the pace of wage increases quickened somewhat in the third quarter. Compensation per hour worked in the private nonfarm economy rose at an 8.5 percent seasonally adjusted annual rate, up 1 percentage point from the rate of growth over the first half of this year but below the quarterly increases posted in 1974. Output per hour worked, which typically exhibits the largest advances in the early part of the recovery period, moved ahead at a 9.4 percent seasonally adjusted annual rate. As a result of these changes, unit labor costs edged downward at a 0.8 percent annual rate in the third quarter.

According to data gathered by the Labor Department on major collective bargaining settlements, the average effective wage of approximately 10 million unionized workers has risen at a 9.6 percent annual rate over the first nine months of the year, about the same as the 9.4 percent increase recorded in 1974. The average effective wage adjustment reflects first-year increases negotiated in the current quarter, deferred increases under earlier contracts, and cost-of-living raises accumulating under current and previous contracts. There was a sharp run-up in the effective wage rate in the third quarter, due to a substantial increase in cost-of-living adjustments as well as to larger deferred increases. For the entire private nonfarm economy, average hourly earnings—which are conceptually similar to the effective wage adjustments in the unionized sector—advanced at a seasonally adjusted annual rate of 7.1 percent, above the rate of increase in the first two quarters of the year. A better indicator of the level of wage rates in the private nonfarm economy, however, is the adjusted average hourly earnings series, since it abstracts from fluctuations in average hourly earnings which are attributable to interindustry shifts in employment and variations in overtime hours in manufacturing. In terms of quarterly averages, the adjusted average hourly earnings series posted a seasonally adjusted annual rate of growth of 8.3 percent in the July-September period, up slightly from the 7.8 percent increase during the first half of the year but below the 9 percent rise in 1974.

Nonfarm employment posted increases in both the household and payroll surveys in the month of October. However, a substantial increase in the labor force combined with a large reduction in agricultural employment resulted in a 0.3 percentage point increase in the civilian unemployment rate. According to the payroll survey of establishments, seasonally adjusted payroll employment increased by 217,000 workers in October, marking the fourth consecutive month of healthy payroll gains. As in previous months, manufacturing payrolls played an important role in the rise, accounting for about half of the October increase. The remainder of the rise was distributed between the services and government sectors. In the separate survey of households, nonagricultural employment moved ahead by 147,000 workers. However, agricultural employment fell by 124,000 workers in the month so that civilian employment was little changed on balance. At the same time, the labor force posted a substantial gain of 252,000 workers, and the seasonally adjusted civilian unemployment rate rose by 0.3 percentage point to 8.6 percent of the civilian labor force.

# The Business Situation

Economic activity is continuing to expand, but the upward impetus is narrowly based and has slackened somewhat in recent months. In October, there was a discernible slowdown in the pace of the recovery from that recorded for the third quarter.* While industrial production rose for the sixth consecutive month, the October advance was less than half as large as the average of the earlier months and was also not so broadly diffused. Similarly, there was an appreciable slowing in the growth of nonagricultural employment in November. Yet, because of a large drop in the civilian labor force in that month, the unemployment rate declined to 8.3 percent, the same level that had prevailed in September.

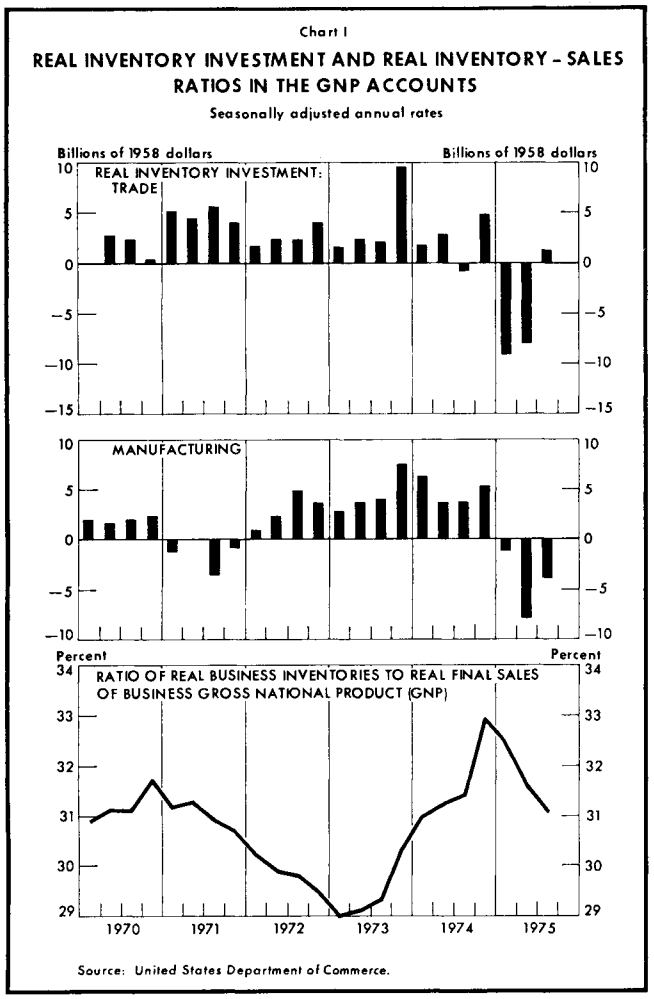
The latest readings of the other monthly business statistics also point to a temporary lull in the economic recovery. Retail sales have been relatively sluggish since July, following several months of very large increases. Consumption spending may be buoyed in months to come, however, by continued advances in personal income. Single-family housing starts have recovered substantially during the past six months, but construction of apartment buildings remains slow. Capital spending has also remained weak. There are increasing signs that inventory liquidation is drawing to a close. Businesses have clearly gone a long way toward paring their excess inventories and have succeeded in establishing a much better balance between sales and inventories.

Despite the occasional monthly flare-ups, the inflation rate appears still to be hovering around the 7 to 8 percent range. While this is unusually rapid by historical standards, it still represents a major improvement over the prolonged double-digit increases recorded last year. Consumer prices, led by a fairly stiff increase in retail food prices, accelerated a bit in October. Excluding food, however, the October rise in consumer prices was actually below the average for the previous six months. Wholesale prices were unchanged in November, as the large drop in agricultural prices offset the moderate advance in the prices of industrial commodities. Looking ahead, there appears to be little reason to anticipate a fresh burst in the rate of inflation in the coming months. There has, in fact, been some easing in the rate of increase in nonfood consumer commodity prices in recent months, and retail food price increases are currently expected to slow considerably as the record 1975 crops come to market. Also, the large gains in productivity typically associated with the early phases of economic recovery may help to blunt some of the inflationary pressures arising from the sizable increases in wages. Moreover, the substantial slack in the labor market is likely to exert a restraining influence on wage increases for some time to come, particularly in less organized sectors of the economy. However, there are major questions surrounding the large number of major collective bargaining agreements scheduled for 1976.

### INVENTORIES AND INDUSTRIAL PRODUCTION

It appears that most of the once massive inventory overhang has largely been eliminated, and some businesses have begun to replenish their depleted stockpiles. Measured on a GNP basis, the real inventory-sales ratio for the business sector declined further in the third quarter to the lowest level since the opening quarter of 1974 (see Chart I). This level, it may be noted, is in line with past experience at similar stages of cyclical recoveries. At the same time, the rate of inventory liquidation was much reduced from what it had been earlier in the year. Within the trade sector, while wholesalers were still reducing their real inventory stocks during the third quarter, retailers had actually begun to add to theirs. However, the book value data suggest that a turnabout in inventory investment may have occurred in the wholesale trade

* According to revised estimates, the increase in real gross national product (GNP) amounted to a 13.2 percent annual rate in the third quarter, up 2 percentage points from the preliminary estimate. The rate of inventory liquidation was revised downward, while the advance in real final sales was revised upward. The rate of growth of the implicit price deflator for GNP was also adjusted downward slightly to a 4.7 percent annual rate. Released along with the GNP revisions were preliminary estimates of corporate profits in the third quarter. Pretax corporate profits, expressed at an annual rate and adjusted for changes in inventory valuation, increased an estimated $17.6 billion to $122.5 billion.




sector as well at the end of the third quarter. Within the manufacturing sector, the liquidation of real inventories continued in the third quarter but at about half of the pace of the preceding quarter. In October, nondurables manufacturers posted their third consecutive monthly gain in the book value of inventories. The book value of durables manufacturers' inventories, however, registered another decline. This drop more than offset the gain for nondurables manufacturers, but the net decline for the total manufacturing sector was the smallest this year.

The Federal Reserve Board's index of industrial production posted a moderate 0.4 percent gain in October. While this marked the sixth consecutive monthly rise, the October advance was less than half as large as the average of the earlier months and was also not so broadly distributed. Consumer goods output continued to climb in that month, but the output of capital goods and defense equipment slipped back after previous advances. Symptomatic of the more sluggish growth in the production pipeline, the increase in output of materials in October was less than one fourth as large as the average gain for the previous four months. Iron and steel have once again resumed the declining pattern evidenced throughout most of 1975 and interrupted only briefly in August when there was a bunching of purchases by steel mill customers, an effort apparently aimed at stocking up before the announced price increase took effect on October 1. If output were to continue to grow at the markedly slower October pace, it would take quite a while before production recovered the ground lost during the recently ended recession. As of October, industrial production was still 8.6 percent below the November 1973 peak. Furthermore, the Wharton index of capacity utilization for the industrial sector stood at 80.3 percent in the third quarter, 16 percentage points below the peak recorded two years earlier.

## PERSONAL INCOME, CONSUMER SPENDING, AND RESIDENTIAL CONSTRUCTION

Personal income posted another solid gain in October, amounting to $12.7 billion at a seasonally adjusted annual rate. Wage and salary disbursements rose by $8.7 billion, and this marked the eighth consecutive month of growth. About $2 billion of the October increase in wages and salaries was attributable to a pay raise for Federal Government employees. The rest of the increase in wage and salary disbursements was widespread across payroll categories.

After fairly rapid growth earlier in the year, consumption spending has been flat in recent months. Retail sales in October were only slightly above the level of July, and this sluggish pattern for the monthly sales figures has characterized both durables and nondurables sales categories. Domestic automobile sales also exhibited little buoyancy over the July-November period. To be sure, the succession of sizable monthly advances in personal income continues to provide the wherewithal for further gains in coming months. Perhaps, though, consumers' lingering uncertainties about employment prospects and inflation may be tempering the strength of the recovery in consumer spending. For example, while the index of consumer sentiment, as measured by the Survey Research Center at the University of Michigan, rebounded in the second quarter from the all-time low recorded in the first quarter, it showed little further progress in the third quarter and remained at a low level by historical standards.

Thus, the relatively flatter pattern for retail sales since midsummer may be an indication that consumers have taken cautious wait-and-see attitudes at this early point in the recovery.

Residential construction appears to be showing some tentative signs of improvement. To date, the recovery in housing starts compares rather favorably with the upswings in past housing cycles, although the current recovery has proceeded from a very depressed level. In October, housing starts were running at a 1.46 million unit annual rate, up slightly more than 200,000 units from the third-quarter rate. Almost all of the increase was in single-family starts. Building permits, which had risen about 10 percent in September to their highest level since June 1974, were essentially unchanged. Yet, despite the rebound in housing starts, a number of factors suggest that the rate of recovery in housing in the near term will be more sluggish. Although the overhang of unsold new single-family homes has been reduced considerably, the backlog nevertheless remains high. Even more importantly, mortgage terms have remained tight despite large savings inflows. Lenders seem hesitant to issue new mortgages, perhaps because of fears of rising interest rates and induced outflows. At the same time, demand remains weak as buyers face large uncertainties over the economic outlook and high home prices, and the run-up in energy costs probably continues to discourage prospective buyers.

## NEW ORDERS, CAPITAL SPENDING, AND LEADING INDICATORS

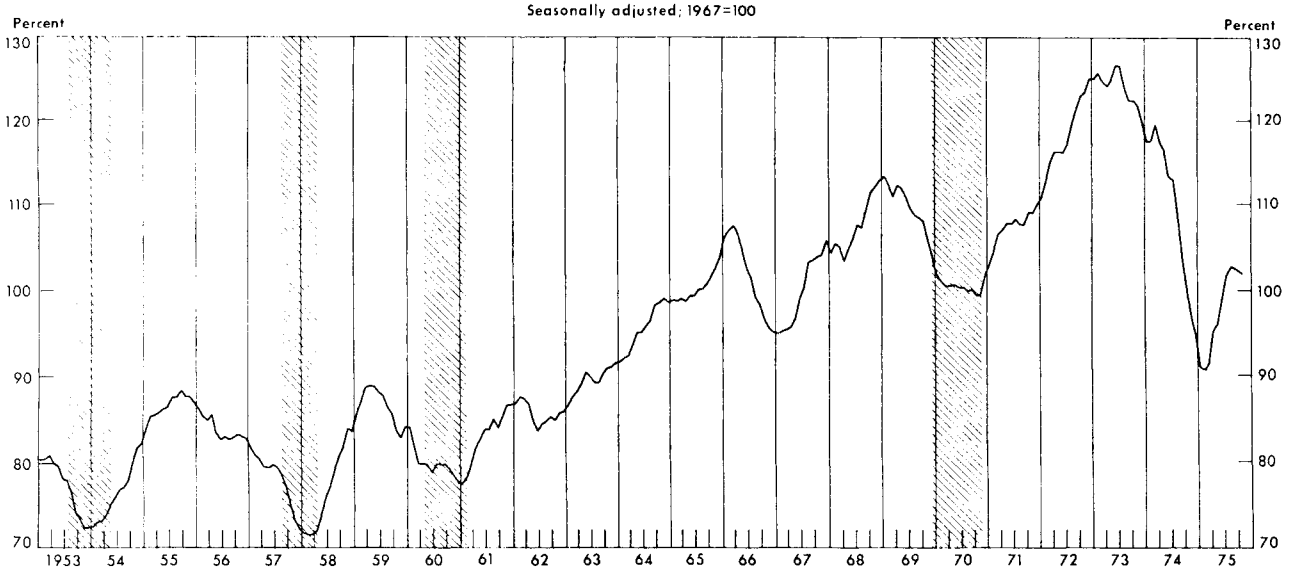
After dropping in the previous month, the flow of new orders received by durable goods manufacturers advanced in October. Actually, the October gain would have been bigger but for a fairly large decline in the bookings for defense goods, a development unrelated to the current state of business conditions. Excluding new defense bookings, the increase in new durables orders amounted to $0.9 billion in October, which more than erased the dip of the preceding month and which was a bit above the average monthly gain recorded over the March-August period. As shipments of durable manufactured goods also rose in October and exceeded new orders, the backlog of unfilled orders edged down further, continuing the pattern of the past year. In contrast, at this stage of the recovery during previous postwar upturns, the backlog of unfilled durables orders had usually begun to rise.

While real business capital spending leveled off in the

Chart II

COMPOSITE INDEX OF LEADING INDICATORS

Seasonally adjusted; 1967=100




Note: Shaded areas represent recession periods, indicated by the National Bureau of Economic Research (NBER) chronology. The latest recession has not yet been dated by the NBER.

Source: United States Department of Commerce, Bureau of Economic Analysis.

third quarter following four quarters of declines, there are no signs of any exuberance in this sector, where recovery typically lags behind that in other sectors. The recent McGraw-Hill survey of planned capital outlays points to a 9 percent rise for 1976 with an equal increase in capital goods prices, thus implying no gain in real spending levels. A similar projection was obtained by the Commerce Department in its October-November survey of planned plant and equipment spending; it was reported that businesses expect to step up their capital outlays in the first half of 1976 at a 10.6 percent annual rate, compared with what they were planning to spend during the second half of 1975. While the various surveys have generally tended to underestimate capital outlays in the first years of recoveries, the lackluster outlook evidenced by the surveys is corroborated by recent monthly data on new orders for nondefense capital goods. Although new orders rose in October, the most recent month for which data are available, they were slightly below their July level.

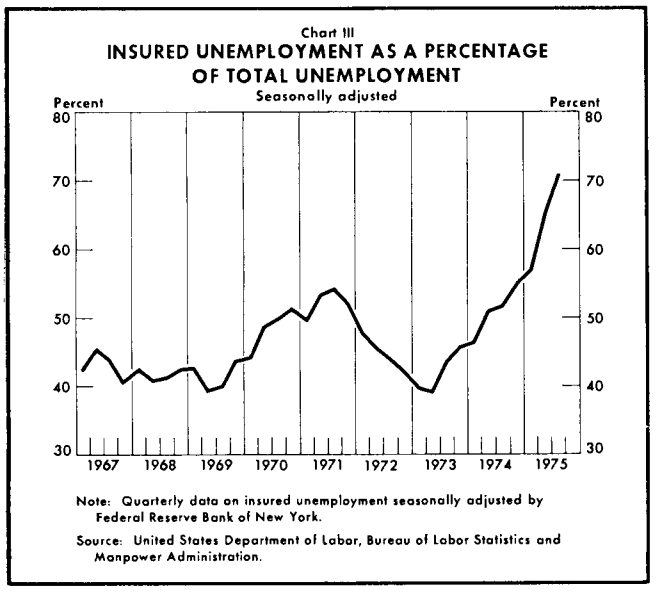
An interesting barometer of economic activity is the composite index of leading indicators, which is assembled and published each month by the United States Department of Commerce. The index is made up of a dozen individual data series and is designed to provide an advance reading on the direction of economic activity. Several of the data series, such as net business formation, building permits, new orders for consumer goods and materials, and contracts and orders for plant and equipment, represent early indications of spending intentions. After a while, these decisions show up as actual expenditures. Other data series, such as the average workweek, the layoff rates, changes in the wholesale prices of crude materials, and vendor performance, reflect the decision of managements in reaction to the perceived strength of prospective demand. Also included in this index, but harder to characterize, are common stock prices, the real money stock, and changes in total liquid assets.

The revised composite index of leading indicators has fallen in each of the past two months from 102.6 in August to 102.0 in October (see Chart II). The question arises whether this drop points to a downturn in economic activity or to a slowdown in the rate of growth. An examination of past episodes where the index declined in two successive months after increasing in previous months reveals that the most recent two-month decline is the smallest in the postwar period. The two components that declined for two straight months and accounted for most of the drop in the index were the real money supply and liquid assets. However, it appears that the real money supply expanded strongly in November following contractions in the two previous months. In addition, the rebound of the composite index of leading indicators prior to the declines in the past two months had been quite strong, compared with the upturn pattern in past early recoveries. It should be noted that, as a recession predictor, the composite leading indicators series has exhibited a number of false signals. For example, downturns in 1962, 1963, and 1968 were not followed by major downturns in economic activity. However, the sluggish pattern of the index in the past two months is consistent with the pattern of slower growth exhibited by a number of other monthly series and may be an indicator that the pace of the recovery in the near term will remain considerably below the extremely rapid third-quarter rate.

## LABOR MARKET DEVELOPMENTS

The slackening pace of the economic recovery has carried over to the labor market. In November, nonfarm employment was essentially unchanged in both the household and payroll surveys. According to the payroll survey of establishments, seasonally adjusted payroll employment edged up by a scant 41,000 workers following four months of very hefty gains. Indeed, from June to October, the increment in payroll employment amounted to more than 1.2 million workers. In the separate survey of households, nonagricultural employment dipped by 33,000 workers and agricultural employment fell by 130,000 workers subsequent to a similar decline in the previous month. However, the civilian labor force, which often exhibits volatile movements on a monthly basis, fell by a substantial 464,000 workers. Because of the proportionately greater decline in the labor force, the seasonally adjusted civilian unemployment rate fell 0.3 percentage point to 8.3 percent of the labor force, bringing it back to its September level.

While the average number of unemployed workers has been substantially higher in 1975 than in the previous year, there has also occurred a sharp increase in the proportion of unemployed workers who are eligible for unemployment insurance benefits (see Chart III). For those who are eligible, these benefits act partially to replace the income lost due to unemployment. By acting as a cushion for lost wage and salary income, unemployment insurance benefits also tend to stabilize aggregate consumer outlays on goods and services. These benefits are a particularly potent stabilizer since they are not subject to the personal income tax or social security payments. Typically, the fraction of unemployed workers eligible for benefits rises during recessions. This partly reflects the greater numbers of adult men and job losers among the ranks of the unemployed; these groups have larger fractions who qualify




to receive unemployment insurance benefits. In the most recent recession, new legislation which temporarily extended the benefit period has also had an impact in raising the proportion of unemployed workers who receive benefits. This proportion has in fact risen throughout 1975 to 70.9 percent in the third quarter, by comparison with a figure of 51 percent for all of 1974.

Although the tempo of wage rate increases appears to have picked up in the two most recent months, the monthly wage data typically exhibit considerable variability, and the overall rate of wage inflation seems to be about in line with that registered in the third quarter. In the July-September interval, average hourly earnings in the private nonfarm economy, adjusted for interindustry shifts and overtime in manufacturing, advanced at an 8.4 percent seasonally adjusted annual rate. This was identical to the gain in the first quarter of this year but slightly above the second-quarter rate of advance. The advances in adjusted average hourly earnings in October and November brought the three-month growth in the adjusted index to a seasonally adjusted annual rate of 8 percent.

## PRICES

Although there have been a number of flare-ups in both wholesale and retail prices in recent months, it appears that the typical pattern of moderating price increases in early recovery phases is continuing in the current recovery. The twelve-month growth rate in the consumer price index, which smooths out much of the monthly volatility of retail prices, has fallen steadily over 1975. In October, the twelve-month growth rate in consumer prices stood at 7.6 percent, down substantially from a figure of almost 12 percent with which the year began. This slowdown reflects continuing moderation in recent months in consumer nonfood commodity prices and services prices (apart from higher New York City subway fares in September). In addition, there is the encouraging prospect that food price increases are likely to slow considerably as the record 1975 crop comes to market.

On a seasonally adjusted basis, the wholesale price index in November was virtually unchanged from the level of the previous month. This development reflected a substantial drop in the index for farm products and processed foods and feeds, combined with a moderate increase in wholesale prices of industrial commodities. Wholesale prices of farm products and processed foods and feeds fell at a seasonally adjusted rate of 1.2 percent (not annualized) following very rapid gains in the previous two months. While these prices have been advancing fairly rapidly in the past six months, as of November they actually stood slightly below the level of a year ago. Prices of industrial commodities rose at a 0.6 percent seasonally adjusted rate in November, marking the first month since April that the rate of increase in these prices did not accelerate further. It should be pointed out, however, that prices of nonagricultural intermediate materials and supplies, which are an important input for nonfood commodities at the retail level, have advanced at a 7.5 percent seasonally adjusted annual rate over the past three months. In November, these prices stood 5.2 percent above the year-ago level.

Consumer prices climbed at a 0.7 percent seasonally adjusted rate in October, a somewhat faster rate of increase than the moderate gains of the two previous months. All the acceleration, however, was attributable to the run-up in the volatile food prices component. According to the Department of Agriculture, however, the growth of retail food prices should moderate to a 4-5 percent annual-rate range in the first half of 1976. Consumer prices of nonfood commodities, which had risen at an average annual rate of about 7 percent in the first three quarters of the year, have averaged about a 5 percent annual rate over the three most recent months. Increases in the prices of services have remained moderate in recent months, apart from the September spurt which largely reflected higher subway fares in New York City.

# The Business Situation

The pace of the economic recovery apparently picked up toward the year-end, following a marked slowdown in the fall. In December, there were sizable gains reported in nonagricultural employment, the average workweek, and overtime hours. To be sure, the unemployment rate held steady at 8.3 percent, but this reflected an outsized December increase in the civilian labor force. At the same time, retail sales surged ahead on a wide front, including an advance in domestic car sales. Retail sales had exhibited only modest increases between July and November, while automotive sales were virtually flat. In coming months, continued growth in consumption spending seems likely now that a compromise has been reached on tax legislation between President Ford and the Congress. Under this agreement, the 1975 tax cuts will be extended to the end of June of this year, and the Congress issued a promise to consider limits on Federal Government spending in fiscal 1977.

In the price area, a major source of near-term uncertainty was also cleared up when the President signed the Energy Policy and Conservation Act into law on December 22. The new legislation establishes an upper limit on the average price of domestically produced oil which is more than $1 per barrel lower than the average price prevailing at the end of 1975. It also provides for some rather modest increases in domestic oil prices over the longer term. At the same time, the Administration has removed the $2 per barrel duty on imported oil. The near-term impact of these actions will probably be a reduction in crude oil prices; in the absence of the new legislation, there would have been a major inflationary shock as a result of immediate decontrol.

The recent price news has been reasonably favorable on balance. In December, wholesale farm and food prices fell substantially for the second consecutive month; industrial wholesale prices continued to rise more rapidly than earlier in the year but sharply below 1974 rates of advance. In November, retail prices of commodities other than food continued their recent, quite moderate performance. Retail food prices, however, while rising less than in October, still showed a somewhat disappointingly rapid advance. Looking ahead, the current projections of the Department of Agriculture indicate a relatively modest 4 to 5 percent annual rate of increase in retail food prices in the first half of 1976, less than half the rise recorded in the second half of 1975. Of course, these estimates are subject to substantial change because of weather conditions and other unforeseen developments.

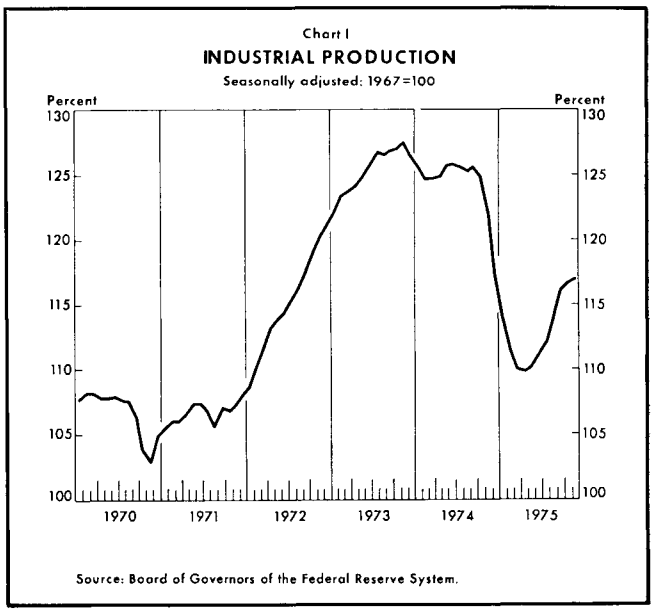
## CONSUMER SPENDING AND RESIDENTIAL CONSTRUCTION

After a brief respite in the fall, consumption spending has lately shown renewed signs of vigor. Indeed, seasonally adjusted retail sales spurted 3.5 percent in December, the sharpest monthly advance since July 1973. By comparison, from July to November the rate of growth in consumption spending had amounted to a sluggish 1.4 percent, virtually all of which was attributable to higher retail prices. The December surge in retail sales was paced by the huge 11.3 percent increase in the automotive sector. Sales of domestic automobiles in December totaled 8.2 million units at a seasonally adjusted annual rate, up 7.9 percent from the preceding month and the highest rate since August 1974. Sizable gains were also recorded in December in sales of both department stores and furniture and home-furnishings stores.

Consumers can now look forward to a continuation of the 1975 tax cut, at least for a while, as a result of the recent compromise worked out between the Congress and the President. Under the compromise, President Ford agreed to extend the tax cut through June 30, 1976. In return, the Congress promised that, should it continue the tax cut beyond this date, it would consider reducing expenditures by an equal amount. Had this agreement not been reached, consumers' tax liability for the first half of 1976 would have jumped by approximately $7 billion. Also scheduled for this year is another increase in social security taxes under legislation that was passed at the end of 1973. In 1975 social security taxes were collected

on only the first $14,100 of wages and salaries, but in 1976 these taxes will be collected on the first $15,300. The higher ceiling will lower spendable income in 1976 by about $1 billion, most of which will take effect in the second half of the year.

Residential construction seems to be gradually recovering from the battered condition it was in at the end of 1974. In November, housing starts slipped by 82,000 units to a seasonally adjusted annual rate of 1.38 million units, but this was greatly overshadowed by the increase of almost 200,000 units in the previous month. Indeed, despite the November decline, the level of starts in that month remained significantly above the average level for the third quarter. Building permits rose in November, reaching their highest level in eighteen months. While housing starts rose substantially in the third quarter, the increase proceeded from a very low level, and the industry remains in a depressed state. The very high levels of mortgage interest rates currently prevailing may continue to exert a considerably dampening influence on the near-term housing recovery.




## INDUSTRIAL PRODUCTION AND INVENTORIES

The Federal Reserve Board's index of industrial production posted a modest increase in November. Although production was up for the seventh consecutive month, the November advance amounted to a mere 0.2 percent, only one-fifth as large as the average gain of the previous six months (see Chart I). At this point, the pace of the current recovery is comparable to that of most previous postwar recoveries. However, while industrial production has risen 6.3 percent above the trough of April 1975, it still remains 8.4 percent below the November 1973 peak. Thus, if production were to continue to expand at the average rate of the past seven months, it would take an additional nine months before the previous peak would again be attained. Output of consumer durables, which has been a bulwark of the recovery, continued to climb in November despite a drop in the output of automobiles. At the same time, production of consumer nondurables was marginally higher. The output of business equipment rose slightly in November following a decline in the previous month. While equipment production has edged up from its July trough, it currently remains well below the peak levels of late 1974. The output of materials rose in November for the sixth consecutive month but by the smallest amount in this period.

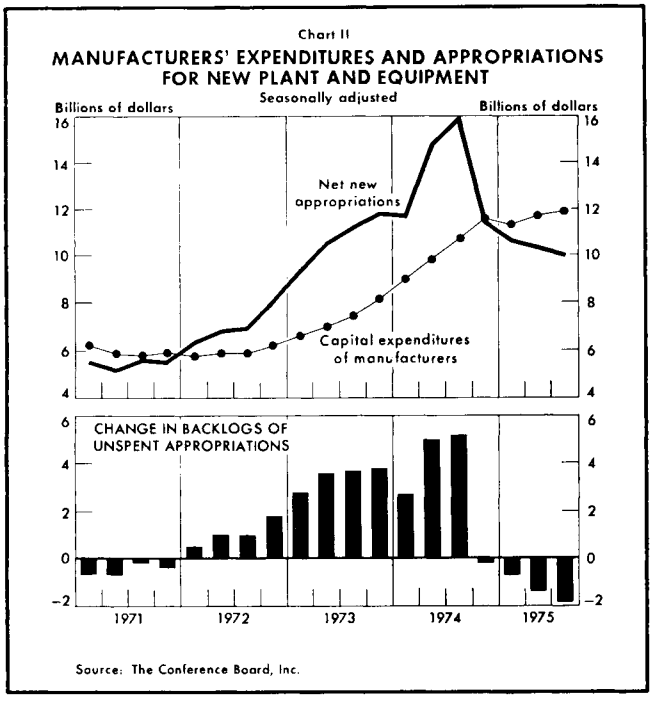
The inventory adjustment process appears to be now largely completed, and some businesses have even begun to rebuild their inventory stocks, albeit at a fairly cautious pace. In the retail trade sector, wherein the inventory liquidation had commenced at the beginning of 1975, physical stocks actually rose in the third quarter. Moreover, in October, the most recent month for which data are available, book value accumulation was about double the average gain in the three previous months. In fact, the ratio of retailers' book value inventories to retail sales has risen three months in a row. While there are conceptual problems in interpreting book value data (and book value to sales ratios) in inflationary periods, the most recent figures suggest a pickup in inventory investment in the retail sector. In the wholesale trade sector, the aggregate book value of inventories has risen in the past three months following declines in all but one of the previous seven months. Book value inventories for manufacturing inched up for the second month in a row in November after seven months of decline. Although inventories in the durable goods sector continued to slide, there seems to be an easing in the rate of liquidation. The November drop was the smallest in seven months and was more than offset by the buildup in nondurable goods manufacturing.

## NEW ORDERS AND CAPITAL SPENDING

The flow of new orders received by durable goods manufacturers declined in November, after rising in the previous month. To a large extent, this seesaw pattern has reflected the monthly movements in export orders for

nonautomotive durable goods. Excluding new defense bookings, durable goods orders fell $1.4 billion in November, which was more than enough to offset the $1 billion increase in the preceding month. Looking at the record of the current recovery, total durables orders bottomed out last March, spurted $6.7 billion from then until August, and declined $1.4 billion from then until November. This pattern is not at all unusual inasmuch as similar ones occurred in the 1955, 1961, and 1971 recoveries. Since shipments in November exceeded new orders, the backlog of unfilled orders edged downward, further continuing the pattern evidenced throughout most of 1975.

Capital spending remains weak, and there are no signs of any exuberance in this sector. According to a recent survey conducted by The Conference Board, net new appropriations for new plant and equipment by the nation's 1,000 largest manufacturers continued to fall in the third quarter, although the decline was the smallest of four consecutive drops beginning in the fourth quarter of 1974 (see Chart II). Actual capital outlays by large manufacturers were up slightly and exceeded net new appropriations, so that the backlog of unspent appropriations declined for the fourth consecutive quarter. Despite these declines, the backlog remains at a relatively high level, suggesting that many projects might have been postponed rather than canceled. For the economy as a whole, real capital spending leveled off in the third quarter, and the October-November Department of Commerce survey points to at least some real growth in capital spending over the first two quarters of the year. On the other hand, a more recent Commerce Department survey indicates a modest decline in real spending for the year as a whole, a development which would be highly unusual at this stage in the recovery.




## LABOR MARKET

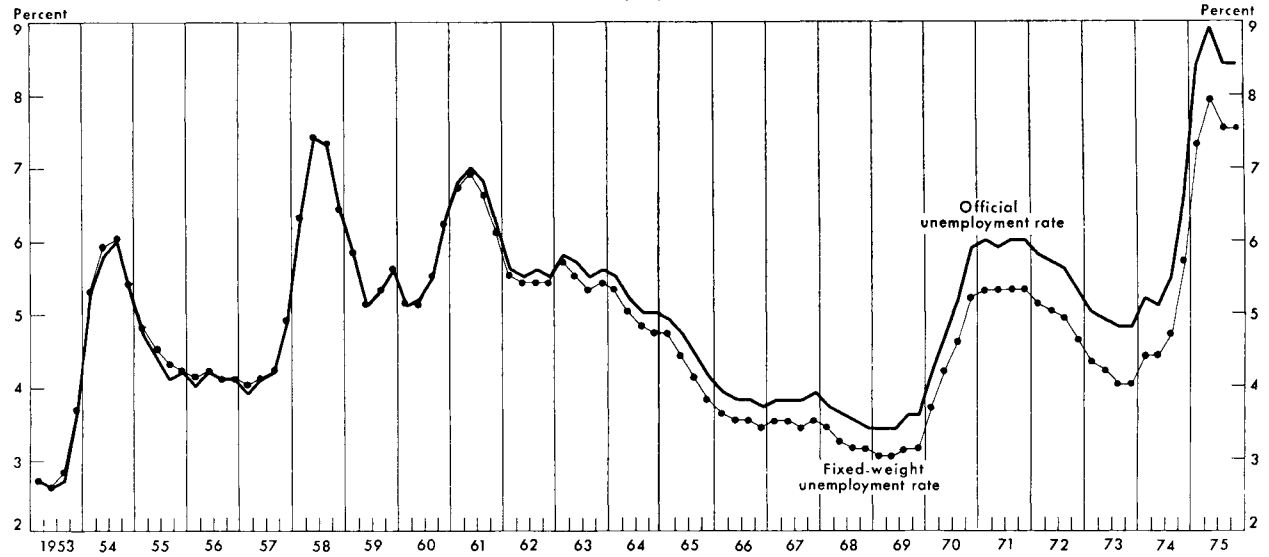
Labor market conditions strengthened appreciably in December, thus ending the year on a positive note. According to the establishments survey, about 240,000 workers were added to the payrolls of businesses in the private nonfarm sector in December. This advance was fairly widely based, and was about one-third larger than the average monthly increment recorded in earlier months of the recovery. Besides hiring more workers, businesses also extended working hours. The average workweek for the private nonfarm economy lengthened in December for the third consecutive month. Within the key manufacturing sector, the average workweek increased 0.4 hour to 40.3 hours, an unusually large monthly advance. In the separate survey of households, the gain in employment amounted to about 230,000 workers, following the slight decline of the previous month. Nevertheless, because of the proportionately equal increase in the civilian labor force, the overall unemployment rate held steady at 8.3 percent. Since peaking at 9.2 percent in May, the unemployment rate has varied between 8.3 percent and 8.6 percent in subsequent months. For the year as a whole, the unemployment rate averaged 8.5 percent, up 2.9 percentage points from the previous year.

Although unemployment certainly remains high by historical standards, the overall unemployment rate appears to overstate to some extent the current degree of labor market slack, compared with earlier years in the postwar period. Over the past two decades, women and teen-agers have constituted an increasing proportion of the labor force. These workers change jobs more frequently than adult males do and also tend to enter and leave the labor force more often. Because an unemployed person is defined as one who is jobless but is looking for work, the relatively frequent spells of looking for new jobs result in higher unemployment rates for women and teen-agers. As the labor force share of these groups rises, so too does the overall unemployment rate. Chart III compares the official unemployment rate with a fixed-weight measure which weights the unemployment rates of the major age-sex

Chart III

A COMPARISON OF OFFICIAL AND FIXED-WEIGHT RATES OF UNEMPLOYMENT

Seasonally adjusted




Note: The fixed-weight unemployment rate was calculated by the staff of the Federal Reserve Bank of New York, using as relative weights the 1956 age-sex composition of the labor force.

Source: United States Department of Labor, Bureau of Labor Statistics.

groups by their relative importance in the labor force in 1956. This latter measure provides a comparison over time, which abstracts from those changes in the overall unemployment rate that arise from relative shifts in the labor force. Based on the age-sex composition of the labor force in 1956, the peak unemployment rate in 1975 was not very much higher than the maximum rates in 1958 and 1961. At the same time, the jobless rate for men aged twenty-five and older has been about equal to the peak rate in 1961 but below the 1958 rate. At least in some respects then, the current degree of labor market slack is roughly comparable to the 1958 and 1961 experiences.

## PRICES

The latest readings on inflation are moderately encouraging on balance. At the wholesale level, prices declined 0.6 percent in December. This decline entirely reflected the large drop in the prices of farm products and of processed foods and feeds. At the same time, the rate of growth of industrial wholesale prices stood at 0.6 percent. This was essentially unchanged from the November advance but remained below the increases recorded in the preceding three months. Among industrial commodities, the largest price increases were posted for lumber and wood products, pulp, paper, and allied products, and cigarettes. The growth in prices of fuel and power continued to be moderate after their sharp midyear flare-up.

Consumer prices rose at a 0.7 percent seasonally adjusted rate in November, a rate of gain about the same as the October advance but somewhat faster than the two previous months. Prices of consumer services rose 1.1 percent in the month, reflecting higher prices for automobile insurance, telephone service, parking, and hospital care as well as higher mortgage interest rates and property taxes. While the pervasiveness of these increases is somewhat disturbing, services prices had been rising at more moderate rates in recent months—apart from the September spurt which largely reflected the New York City subway fare increase. Nonfood commodity prices continued the very modest pattern of increases exhibited in recent months. The November monthly increase of 0.3 percent brought the three-month growth rate of these prices to a seasonally adjusted annual rate of 3.7 percent. Food price increases moderated to a 0.6 percent seasonally adjusted rate after increasing more rapidly in the

previous month. According to the Department of Agriculture, retail food price gains are expected to slow to a 4 to 5 percent annual-rate range in the first half of 1976. This would be about half as fast as the rate of growth recorded for the second half of 1975, compared with the first six months of the year.

In December, the Congress passed the new Energy Policy and Conservation Act, and the measure was signed into law at the end of the month. Many of the provisions of the new law will have a direct bearing on the cost of crude oil to domestic refiners. First, the bill imposes a ceiling on the average price of domestically produced crude oil of $7.66 per barrel, which is more than $1 below the average price prevailing at the end of last year. Under the Emergency Petroleum Allocation Act, there had been a price ceiling of $5.25 per barrel on domestically produced "old" oil—i.e., oil produced from domestic wells but not exceeding the 1972 rate of output from these wells. If President Ford retains this ceiling, then the ceiling price for "new" oil would have to be set at about $11 per barrel. Second, subsequent to the initial rollback, the legislation provides for modest increases in the average price of domestically produced oil. The new law allows the President to raise the ceiling on domestic crude oil prices by at most 10 percent per year until February 1977. From then on, the President can propose increases in the ceiling of up to 10 percent per year, but the Congress has the power to limit the hikes to the overall rate of inflation. Third, to prevent domestic oil producers from taking advantage of the currently higher world price of oil, the new legislation directs the President to establish export restrictions on oil. At the same time the President signed the legislation, he also removed the $2 per barrel duty on imported oil. In the very near term, it is clearly this latter action that will have the dominant impact on the price and quantity of imported crude oil. The physical volume of imported crude oil is likely to rise, and the cost to refiners should fall but perhaps by an amount less than the $2 per barrel import fee. Thus, the immediate impact on the new energy bill will be a reduction in the average price of oil as a result of both the imposition of a ceiling price on new domestic oil and the removal of the import duty on imported oil. Over the longer haul, however, the supply of domestic oil might be reduced in response to additional domestic controls. For one thing, domestic oil suppliers might well expect higher oil prices at some future point when controls would be ended. In this case, there might be some implicit capital gain earned by merely "sitting" on the oil. Hence, domestic oil refiners would have to import additional oil from abroad, and the attendant increase in the effective price of crude oil would no doubt be passed on to consumers.

# The Business Situation

The latest monthly business statistics confirm that the cyclical recovery in economic activity is continuing and, indeed, suggest that it may have gained a firmer footing in recent months. Perhaps the most striking improvements have been reported in the figures on labor market conditions for December and January. The average workweek rose significantly over this period, and there were large additions to private nonfarm payrolls along with even larger gains in household employment. In addition, the overall unemployment rate plummeted 0.5 percentage point in January to 7.8 percent, the lowest level in over a year. Quite possibly, technical problems of seasonal adjustment overstated the January improvement in joblessness, but there is little doubt that overall labor market conditions have strengthened over the past two months. Other recent reports showed strong and broadly based advances in industrial production and retail sales in December, including an improvement in domestic new car sales that was apparently extended further in January. Some other developments, however, have suggested a more moderate rate of expansion overall, as new orders, housing starts, and the composite index of leading indicators all turned in relatively lackluster performances in December.

In the fourth quarter, the rate of growth of gross national product (GNP) in real terms was much lower than in the previous one. But the third-quarter spurt, largely attributable to a marked slowdown in the pace of inventory liquidation, was clearly unsustainable. Now that the inventory situation has stabilized, the pace of the economic recovery will be closely attuned to the rate of growth of final demand. Hence, the fact that all major spending components contributed to the healthy fourth-quarter gain in real final sales can be regarded as an encouraging sign. Other recent developments, such as the extension of the 1975 tax cut and the heady advance in the stock market, are also reassuring in that they enhance the prospect of further increases in consumption spending in coming months.

## GNP AND RELATED DEVELOPMENTS

According to preliminary estimates prepared by the Department of Commerce, the market value of the nation's output of goods and services (GNP) increased at a 12.2 percent annual rate in the fourth quarter. Adjusted for changes in the level of prices, the gain in real GNP amounted to a healthy 5.4 percent. This was less than half the rate of the previous quarter, but that advance was primarily the result of a sharp slowdown in the rate of inventory liquidation. The latest GNP data indicate that the recovery is moving ahead on schedule and that the level of economic activity has regained much of the ground that was lost during the steep recession. As of the fourth quarter, real GNP stood 1.9 percent below the peak attained two years earlier, a vast improvement over the 6.6 percent shortfall recorded in the first quarter of the year. Nevertheless, there is still a great deal of slack within the economy, inasmuch as the potential productive capacity of the economy has continued to grow over the last couple of years. For the manufacturing sector, the Federal Reserve Board's index of capacity utilization stood at 70.8 percent in the fourth quarter, up 3.8 percentage points from the second-quarter trough but 12.5 percentage points below the peak attained in mid-1973.

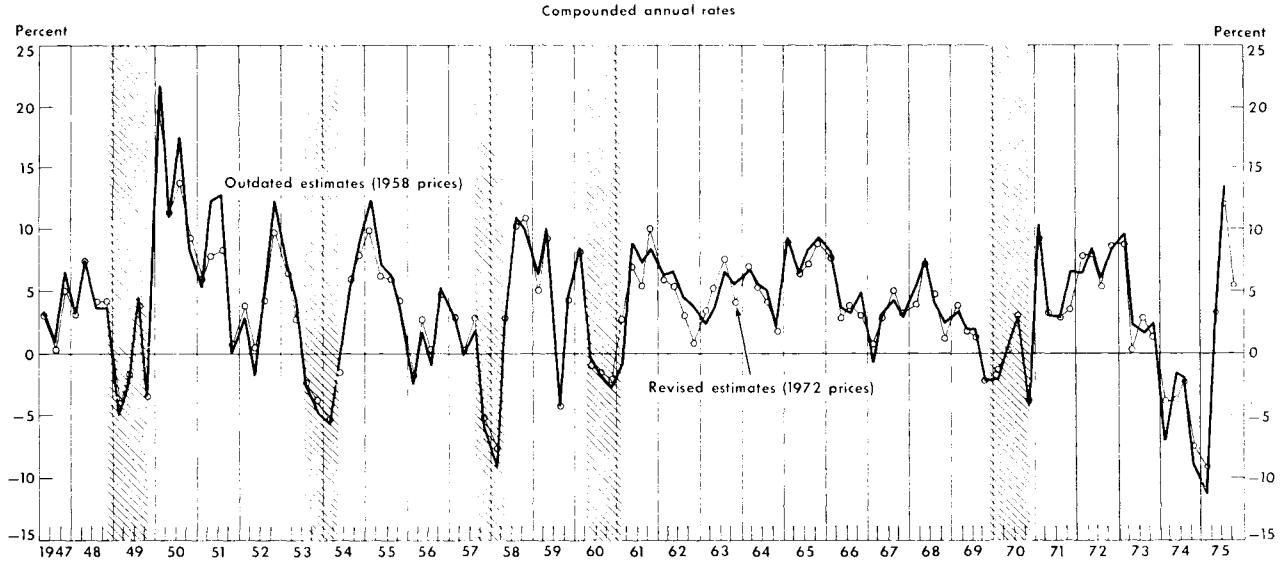
In addition to the preliminary GNP data for the fourth quarter, the Department of Commerce also released revised estimates of GNP for the period from 1946 to 1975. These revisions were quite extensive and incorporate a number of notable features. First, the revisions include the regular updating of the estimates for 1972 to 1974 that was postponed from July 1975. Second, they incorporate new "bench-mark" information based on a number of recent censuses. Third, the new estimates reflect numerous definitional and classificational changes. The most important is the new estimate of economic depreciation which is designed to measure the loss in productive services of the existing capital stock—valued in both current-

dollar and constant-dollar terms. Previously, the quarterly estimates of depreciation in the national income accounts had been based on allowable depreciation charges as defined by the United States tax code and tabulated by the Internal Revenue Service from business tax returns. As a result, these estimates were affected anytime the tax code was changed, and they were valued on a historical cost basis, i.e., in terms of the prices of the capital goods prevailing at the time they had originally been purchased. Fourth, improvements were made in certain statistical estimation procedures, including the incorporation of information obtained in new statistical surveys of inventory accounting methods used by businesses in estimating inventories. Fifth, the base year for the constant-dollar estimates of GNP was updated from 1958 to 1972, and additional information has been used to improve the constant-dollar estimates of construction, producers' purchases of durables equipment, and Government purchases of goods and services. These changes have had a noticeable impact on the recorded rates of growth of real GNP in particular quarters, but they do not appreciably change the cyclical pattern of growth over the postwar period (see Chart I).

The fourth-quarter gain in real GNP was widely distributed among the spending components (see Chart II). Inventory spending turned positive but added little to the momentum of the recovery. Indeed, the turnabout in inventory spending accounted for only about 6 percent of the total gain in real GNP, unlike the previous quarter when its contribution had amounted to about 60 percent. In the fourth quarter, real final expenditures—equal to GNP less the change in business inventories—increased at a 5 percent annual rate, slightly higher than the gains registered in the two preceding quarters. All major spending components contributed to the latest increase in final sales, including fixed investment spending and net exports which had posted declines in the previous quarter.

Businesses have evidently succeeded in getting out from under the once massive inventory overhang and now seem to be keeping an earnestly tight rein on their inventories. For the first time in a year, businesses actually added to their stocks of inventories in the fourth quarter, although the increase was concentrated in the farm sector. Within the nonfarm business sector, there was a further liquidation of inventories, marking the fourth consecutive quarterly decrease. Yet, in some respects, the most recent decline seems to be of a different ilk than the earlier ones. Accord-

Chart I
ALTERNATIVE ESTIMATES OF THE GROWTH RATE OF REAL GROSS NATIONAL PRODUCT
Compounded annual rates




Note: Shaded areas designate recession periods, as determined by the National Bureau of Economic Research (NBER). The most recent recession has not yet been dated.

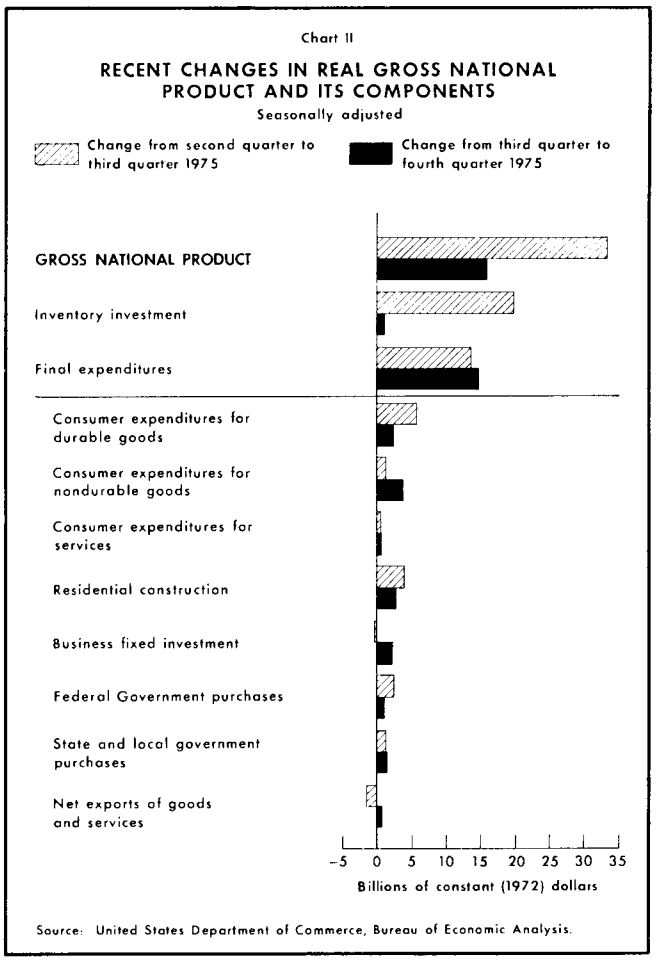
Source: United States Department of Commerce, Bureau of Economic Analaysis.

ing to November data, the most recent disaggregated data available, inventories declined in the wholesale trade and retail trade sectors as well as in durable goods manufacturing. In previous months, both trade sectors had been building up their inventories. This sudden turnaround, together with strong end-of-the-quarter retail sales, suggests that much of the fourth-quarter rundown was unintended, i.e., businesses had geared their production rates to sales expectations that turned out to be too low. In any event, the real inventory-to-sales ratio for the nonfarm business sector edged down further in the fourth quarter, declining to the lowest level in two years. This is one of the clearest signs that the inventory correction has run its course. Thus, changes in inventory investment in the months ahead are unlikely to have the amplifying impact on the cyclical swings in economic activity that they have had over the past year and a half or so.

As inventory spending takes on a more passive role in the current cyclical upturn, consumption spending will come to play an increasingly vital role in setting the pace of the recovery. In the fourth quarter, consumption spending increased at a less than vigorous 3.5 percent annual rate in real terms. Most of the advance occurred in December. In the previous months, retail sales had been flat and this sluggishness had given way to widespread concern over the robustness of the recovery. The December upsurge in retail sales allayed these doubts to a large extent. Moreover, the prospects for further increases in consumption spending have been brightened lately by such developments as the extension of the 1975 tax cut, the steady gains in personal income, and the impressive advance staged by the stock market. Taken together, these developments not only provide consumers with the wherewithal for stepping up their spending but also should help allay the uncertainty and hesitancy that consumers may have about the economic outlook.

In the fourth quarter, personal income outpaced expenditures and the savings rate inched up to 8.2 percent, relatively high by historical standards. For 1975 as a whole, the savings rate averaged 8.3 percent. In the event that consumers do begin to feel less insecure about the economic environment, the savings rate will probably decline a bit. This would add even further momentum to the recovery.

At the end of the year the residential construction sector was continuing to pull out of its very severe recession, although the recovery path was proving to be a rather bumpy one. In real terms, residential housing expenditures increased at a 30 percent annual rate, off somewhat from the previous quarter's gain. Much of this reflected the pickup in construction of new units. Housing starts




were running at a 1.37 million unit annual rate over the last three months of the year, up slightly from the previous quarter but well above the average 1.03 million rate posted for the first six months of the year. Still, there was less residential construction activity in 1975 than in any year since 1946, and the industry remains in a depressed state.

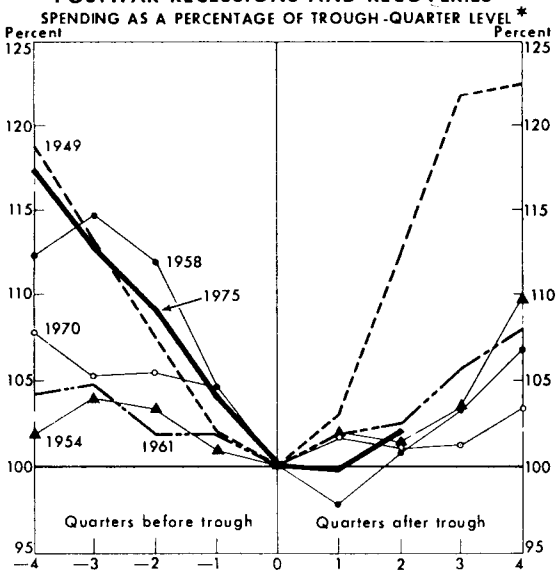
Yet housebuilders can look forward to a somewhat better year, as conditions have lately improved in the mortgage market. In recent months, mortgage interest rates have come down a bit as mortgage funds have become increasingly abundant. The inflow of deposits to thrift institutions rebounded in 1975 from the sluggish rates of the previous year and a half. The thrift institutions have used these funds, in part, to rebuild their liquidity but have lately channeled an increased proportion into

the mortgage market. As a result, growth of their mortgage holdings accelerated between April and October, and then stabilized in November at an annual rate of about 12 percent, the highest since June 1973. At the same time, mortgage interest rates have also reflected the easier conditions. In the January 26 auction, the yield on the Federal National Mortgage Association's insured mortgage commitments was about 90 basis points below the October 7 peak. Mortgage rates on some multiple-family buildings will be lowered even further as a result of a recent action by the Administration. Thus far, construction of multiple-family buildings has staged a very weak comeback. Whereas single-family starts in the fourth quarter of last year had rebounded to better than 75 percent of their 1972 rate, multiple-family starts were at the same time running at only one third of their 1972 rate. To stimulate this sector, the Administration agreed to release $3 billion in funds previously authorized by the Congress—an amount which will enable the Federal Housing Administration to issue mortgages on multifamily buildings at a 7.5 percent interest rate. This infusion of Government funds, along with the increased deposit inflows to thrift institutions, should add impetus to the housing recovery.

Chart III

**REAL BUSINESS FIXED INVESTMENT IN SIX POSTWAR RECESSIONS AND RECOVERIES**

SPENDING AS A PERCENTAGE OF TROUGH-QUARTER LEVEL *




Note: The National Bureau of Economic Research-dated recession troughs occur in fourth quarter 1949, second quarter 1954, second quarter 1958, first quarter 1961, fourth quarter 1970. The trough quarter for the latest recession has not yet been dated by the NBER. Industrial production bottomed out in the second quarter, which is used as the trough quarter in the chart.

* For each reference cycle the trough-quarter level equals 100 percent.

Source: United States Department of Commerce.

In the fourth quarter, business fixed investment spending advanced in real terms, following six consecutive quarterly declines. The gain amounted to an impressive 9 percent annual rate and reflected increased outlays for both structures and capital equipment. This turnabout follows a protracted and very steep contraction in capital spending and has occurred at about the same time in the current cyclical recovery as in earlier ones (see Chart III).

Nevertheless, there is some doubt whether the fourth-quarter advances in real capital spending will be backed up by subsequent increases in the current year. In particular, the most recent (December) Department of Commerce survey of businesses' planned capital outlays for 1976 points to a modest increase in nominal spending but an outright decline of about 4 percent in real terms. In general, there has been a tendency for surveys of planned capital spending to underestimate the actual increases in the first full year of economic recovery. The Commerce Department's special December survey only dates back to 1970, which means there is no long track record by which to judge its forecasting accuracy. Since its inception, however, this survey has proved to be quite accurate. Still, an outright decline in capital spending at this stage of the current business cycle would indeed be an unusual development. In any event, even if there were a decline in capital spending in 1976, it would probably be too small to undermine the economic recovery, though the recovery would of course be slowed down.

## PRICES

Inflationary pressures appeared to let up a bit in the fourth quarter, although the various indicators continued to present a mixed picture that is difficult to interpret. According to the implicit price deflator for GNP, the most comprehensive of the official price indexes, the prices of final goods and services rose at a 6.5 percent annual rate in the fourth quarter, 0.6 percentage point below the advance of the preceding quarter. For the year ended in the fourth quarter, the run-up in the final goods and services prices amounted to 6.4 percent, down from the 11.4 percent increase recorded over 1974. For final goods, the 1975 slowdown in inflation was rather evenly distributed in both consumption and business fixed investment goods. Still, the gap between the rates of inflation for the two classes of goods was rather wide in 1975, as the prices of investment goods rose almost twice as fast as those of consumption goods. While a similar pattern has

occurred during past cyclical recoveries, the difference between the growth rates has not been nearly so large. It could be that this unusually large discrepancy in the rates of inflation between consumption and investment goods has contributed in part to the weakness in the outlook for investment spending.

In recent months, the rates of inflation of consumer and wholesale industrial prices have moved in disparate directions. At the retail level, the average level of prices rose at a 6.6 percent annual rate in the fourth quarter, after increasing at an 8.2 percent rate in the earlier three months. On average in the fourth quarter, total consumer prices stood 7.3 percent above a year earlier, high by historical standards but an improvement over the 12.1 percent surge chalked up in 1974. Increases in nonfood commodity prices continued to moderate in the fourth quarter. The advance in retail food prices also slowed down but remained at an unexpectedly rapid rate. At the wholesale level, industrial prices spurted at a 9.2 percent annual rate in the fourth quarter, more than double that of the preceding quarter and the largest quarterly advance of the year. On average in the fourth quarter, industrial wholesale prices were 6 percent above a year earlier in comparison with the 27.3 percent surge recorded over 1974. Most of the fourth-quarter speedup occurred in October and reflected the large price hikes posted for metals and new automobiles. According to recent newspaper accounts, however, it appears that some of these list-price increases may have been trimmed through either discounting or outright price reductions.

## LABOR MARKET CONDITIONS

According to the labor market data for recent months, the recovery in economic activity has gained a much firmer footing than it appears to have had late last fall. The number of workers on nonagricultural payrolls spurted by about 360,000 in January, up from the 210,000 advance of the previous month and almost three times as large as the average increment recorded from September to November. The January rise was broadly based, as every major industry grouping except mining increased the size of its work force. At the same time, the average workweek lengthened in both the manufacturing sector and the private nonfarm economy. This is a particularly encouraging development, inasmuch as the average workweek has proved to be a fairly reliable indicator of labor market tightness. According to the separate household survey, employment shot up by 800,000, a huge increase by historical standards. Whereas the gain in employment greatly overshadowed the expansion in the civilian labor force, the overall unemployment rate plummeted by 0.5 percentage point in January to 7.8 percent. This was the largest one-month drop in the jobless rate in sixteen years, but technical problems of seasonal adjustment may have overstated the decline.

# The Business Situation

The economy has expanded briskly in the past few months, following a temporary slowdown in the recovery last fall.[1] In January, industrial production again posted a strong and broadly based advance. Solid gains were also recorded at the beginning of the year in new durables orders and personal income, while the composite index of leading indicators registered its sharpest increase since July of last year. Retail sales had spurted in December, and most of this gain held up in January as well. The fact that consumption spending did not retreat to pre-Christmas levels, as some analysts had expected, indicates the underlying strength in this key sector. Labor market conditions have also improved greatly in the past few months. Employment expanded further in February, while the unemployment rate dropped 0.2 percentage point to a fourteen-month low of 7.6 percent.

While the general economy continues to recover, some sectors remain depressed. Most notably, residential construction has yet to show signs of a sustained resurgence, and real business fixed investment also continues to be weak. In time, however, the momentum of the economic recovery should help to revitalize activity in these sectors as well.

Meanwhile, the price situation appears to have taken a turn for the better in recent months. The prices of consumer nonfood commodities rose in January at the slowest rate in over two years, and food prices actually declined. As a result, the rate of advance in the consumer price index slowed to a modest 5 percent annual rate. A marked improvement was also evident at the wholesale level. Agricultural prices dropped in February for the fourth consecutive month, while wholesale industrial prices posted their smallest increase since last spring. Overall, wholesale prices fell in February by the largest amount in a year.

## INDUSTRIAL PRODUCTION AND INVENTORIES

Economic activity continued its upward thrust in January. According to the Federal Reserve Board's index of industrial production, output rose 0.7 percent in that month, marking the ninth consecutive monthly advance. Since bottoming out last April, production has climbed 8.6 percent. Thus far, the progress of the current recovery is quite in line with the rates of expansion experienced in previous postwar recoveries (see Chart I). Nonetheless, because of the severity of the most recent recession, production must still increase an additional 6.9 percent before the November 1973 peak is reattained. Even then, however, output will still fall considerably short of an expanded potential productive capacity.

The January gain in industrial production was broadly based. Across market groupings, output increased for durable and nondurable consumer goods, business equipment, intermediate products, and materials. The gain was also widely distributed among the major industry groupings—durable goods manufacturing, nondurable goods manufacturing, mining, and utilities. Within durable goods manufacturing, output of motor vehicles and parts did decline, but this was the result of cutbacks in the production of automobiles, as the automotive industry sought to bring inventories into balance. Domestic car production slowed from a 7.8 million unit annual rate in December to a 7.6 million rate in January. At the same time, sales of domestic units climbed from an 8.2 million rate to an 8.4 million rate. As a result, car dealers' inventories, which had been as high as 102 days' supply in November 1974, dwindled to a modest 56 days' supply (see Chart II).

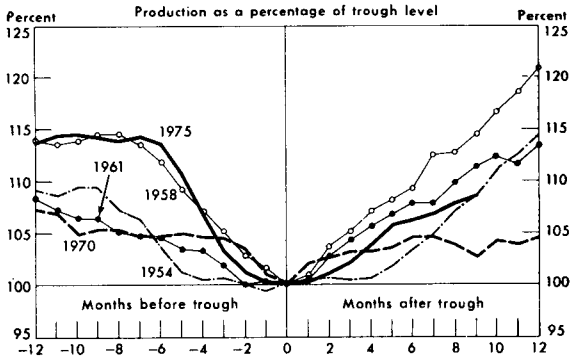
For some time now, the rebound in industrial production has received almost no stimulus from the automotive sector. Indeed, automobile production in January was

[1] According to revised estimates, the advance in real gross national product (GNP) amounted to a 4.9 percent annual rate in the fourth quarter, down 0.5 percentage point from the preliminary estimate. In addition, the level of the implicit price deflator for GNP was revised upward by 0.3 percentage point to 6.8 percent.

virtually identical to what it had been last July. Now, however, excess inventories of automobiles have largely been eliminated. While there still exists a surplus of small cars, which are not selling as well as had been anticipated, there is a shortage of certain large cars, necessitating some plants to work overtime. At the same time, the sales outlook has improved while the import share of the market has declined sharply. Last spring, 22 percent of all cars sold were imported; in January, the proportion amounted to 12.5 percent. These conditions all point to a pickup in domestic automobile production. Indeed, the first signs of this were visible in February, when automobile production jumped to an 8.1 million unit rate.

In the months ahead, industrial production should get a further boost now that excess inventories in other industries have also mostly been eliminated. Overall, business inventories declined in December for the second consecutive month, as inventories in the retail trade sector were once again pared. In terms of constant dollars, the business inventory-sales ratio fell in the final quarter of 1975 to its lowest value in two years. Whereas earlier inventory reductions had been deliberately engineered, the most recent rundown appears to have been largely unintended. Retailers, who in previous months had been adding to their stocks, were apparently caught off guard by exceptionally strong Christmas sales, and to meet these sales they were forced to deplete their inventory stocks. The wholesale trade and nondurables manufacturing sectors can also be expected to participate in an inventory buildup. Indeed, inventories in these sectors actually rose in December. Only in durable goods manufacturing, which experienced its tenth consecutive monthly decline, does it appear that inventories may still be greater than desired. Yet, even in this sector, the December reduction amounted to the smallest since April, suggesting that durables manufacturers will soon begin to build up their inventories. Thus, for the economy as a whole, the near-term outlook is for inventory accumulation, but businessmen, hurt by excess inventories in the past year or so, are likely to exercise restraint in replenishing their stocks.

Chart I
INDUSTRIAL PRODUCTION IN FIVE ECONOMIC RECESSIONS AND RECOVERIES




Note: The National Bureau of Economic Research has determined that the first four troughs occurred in the following months: May 1954, April 1958, February 1961, and November 1970. The trough for the latest recession has not yet been dated. Industrial production bottomed out in April, which is used as the trough month in the chart.

Source: Board of Governors of the Federal Reserve System.

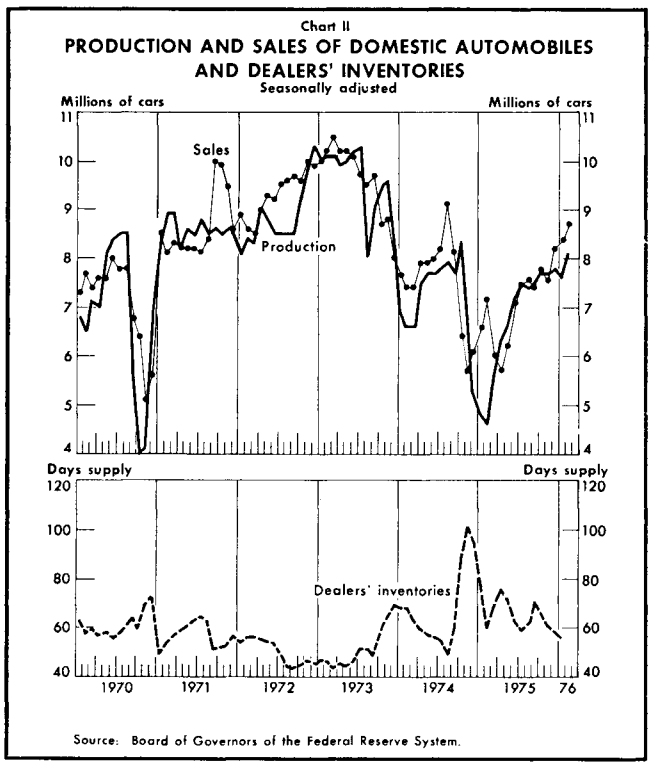
## NEW ORDERS AND CAPITAL SPENDING

After being essentially flat for four months, the flow of new orders received by durable goods manufacturers increased 3 percent in December, according to upwardly revised data, and advanced another 2.2 percent in January. Because this series is a leading indicator of future economic activity, its lack of exuberance last fall had caused some concern that the recovery might have prematurely stalled. Hence, the recent upturn is especially heartening in that it has helped to dispel such fears. The advance in new orders, however, has not been uniformly distributed across sectors. In particular, new orders for nondefense capital goods have remained sluggish, dropping sharply in December before edging up in January. Durables shipments exceeded orders in January for the fifth straight month, and the backlog of unfilled orders continued to slide.

The lackluster performance of new orders for nondefense capital goods no doubt reflects the lingering weakness in capital spending. Although real business fixed investment did turn positive in the fourth quarter, following six consecutive quarterly declines, recent surveys on planned capital expenditures point to a decline in real investment in the coming months. These predictions may, however, be unduly pessimistic. As sales continue to increase, businessmen may revise upward their plans for investment, especially now that the profit picture has improved. Moreover, prospective capital outlays have traditionally been underestimated in the surveys at this stage of the business cycle.

## CONSUMER SPENDING, PERSONAL INCOME, AND RESIDENTIAL CONSTRUCTION

According to advance data, retail sales in January edged down slightly following the December surge. Nevertheless, the fact that retail spending held up as well as it




did in January was widely regarded as a sign of underlying strength. Although monthly movements have been quite erratic, the trend in retail sales is clearly upward. Indeed, over the past four months, sales have advanced at an annual rate of about 12 percent. January's decline was more than accounted for by lower sales in the automotive sector. Despite an increase in unit sales of domestic automobiles, initial reports indicate that total sales in the automotive sector—which includes, among other things, purchases of used cars as well as imported cars—fell sharply below December's level. Excluding the automotive component, sales actually advanced 0.6 percent.

The outlook for future increases in consumption spending remains bright, as personal income is continuing to rise. In January, personal income climbed at a 13.6 percent annual rate, the sixth consecutive monthly advance. Over this six-month period, personal income has grown, on average, at an 11.6 percent annual rate. The bulk of the January gain came from higher wage and salary disbursements, as increased man-hours were translated into increased payrolls. The continued sharp rise in income may soon be matched by an increased willingness to spend. As consumers gain confidence that the economy is recovering, they are likely to cut back on their savings, now at a historically high rate. There are already signs of a renewed willingness to buy on credit. Consumer instalment credit rose in January by the largest amount in seventeen months.

The residential sector is one area where spending has remained weak. Although this sector is in much better shape than a year ago, it has yet to show signs of a sustained healthy resurgence. Indeed, in January, for the third consecutive month housing starts slipped. Even here, however, there are reasons for optimism. Early this year, the Administration agreed to release $3 billion in Federal funds for the purpose of lowering mortgage interest rates on certain multiple-family housing to 7.5 percent. This should stimulate the multifamily sector, which has been the most depressed. Single-family housing should also benefit from lower mortgage rates which have fallen considerably below last fall's lofty peaks. Another encouraging sign is the dwindling backlog of new housing. January's inventory-sales ratio for new one-family homes was the lowest in three years. Finally, building permits jumped 10.7 percent in January to reach a twenty-month high.

## LABOR MARKET

Conditions in the labor market strengthened further in February. The number of workers on nonagricultural payrolls showed a healthy gain of 210,000, as most major industries continued to add to their payrolls. Average hours of work did slip—both in manufacturing and in the private nonfarm economy—but still remained at or above their 1975 highs.

According to a separate survey of households, nonagricultural employment expanded by almost 300,000 workers, while total civilian employment increased slightly, following an outsized gain in the previous month. At the same time, the size of the civilian labor force was virtually unchanged. Hence, the unemployment rate fell 0.2 percentage point to 7.6 percent in February, the fourth straight month of declining joblessness. February's drop in the unemployment rate was particularly reassuring. Because of possible seasonal adjustment problems, many analysts thought that the decline registered in the previous month might have been overstated, with some predicting an upturn or at least a leveling-off in February. The fact that the jobless rate continued to fall, however, suggests that recent data showing improvements in the labor market have primarily reflected underlying market conditions rather than misestimation of seasonal factors. With the strengthening of the economy, civilian employment now

has returned to its pre-recession peak while the unemployment rate, although still high by historical standards, is at its lowest level in fourteen months.

## PRICES

Wholesale prices declined in February, marking the fourth consecutive month that these prices have either fallen or held steady. The drop, 0.5 percent (not annualized), was the largest of the past year. Price increases for industrial commodities continued to decelerate (see Chart III). February's 0.3 percent advance was only half as fast as the average rate of the previous six months. One of the most encouraging signs was the turnaround in the prices of crude materials. Between November and January, these prices had advanced at an average of 1.6 percent per month. Moreover, the National Association of Purchasing Management revealed that in recent months a growing percentage of its members have faced rising materials prices. Because price increases tend to work through by stage of process, there had been some concern that wholesale prices of finished products might accelerate in the near future. But, with wholesale prices of crude materials declining 1.2 percent in February, that now appears at least somewhat less likely. Wholesale food prices also declined in February. Thanks to 1975 record harvests, the prices of farm products and processed foods and feeds have now fallen 7.6 percent since October.

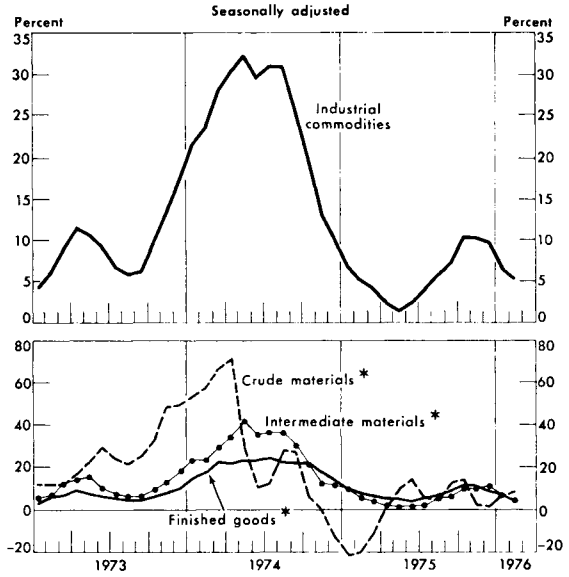
The effect of lower food prices at the wholesale level was manifested to consumers in January. After rising 0.6 percent in both November and December, the food component of the consumer price index declined in January by 0.2 percent. Because wholesale food prices typically lead retail prices by several months, the near-term outlook for consumers' grocery bills is bright. The Department of Agriculture predicts that food price increases will be limited to 1 percent in each of the first two quarters of 1976. What will happen after that, however, is especially uncertain, since it will depend in large part on weather conditions. Of particular concern are the winter drought and dust storms of the grain belt, which have caused the Department of Agriculture to lower its estimates of harvest yields.

The overall consumer price index advanced at a 5 percent annual rate in January, 1.5 percentage points below the rate of the previous month.[2] Nonfood commodities continued their pattern of moderate inflation and rose at a 2.4 percent rate, abetted by a drop in energy prices. This marked the fifth consecutive month in which prices of nonfood goods have increased at less than a 5 percent rate. On the other hand, services prices accelerated in January to a rate almost double that of the preceding month. Part of the run-up was attributable to a one-shot boost in postal rates. Another portion, more worrisome, reflected higher medical costs and automobile insurance rates, which have both risen fairly rapidly in recent months.

Chart III

INDUSTRIAL WHOLESALE PRICES BY STAGE OF FABRICATION

Change from 3 months earlier at annual rate
Seasonally adjusted




* Excludes foods and feeds.

Source: United States Department of Labor, Bureau of Labor Statistics.

[2] Beginning with the January data, the Bureau of Labor Statistics has revised its procedures for seasonally adjusting the series that make up the consumer price index. Adjusted values of the indexes are now derived by adding together their seasonally adjusted components, whereas before the total consumer price index and its major components had been seasonally adjusted independently of each other.

# The Business Situation

The latest business statistics indicate that the economic recovery is continuing at a fairly vigorous pace. During February, retail sales advanced strongly and industrial production moved up at a moderate rate. The increase in economic activity has been reflected in significant gains in employment, and the unemployment rate eased further to 7.5 percent in March. In the last few months, consumer buying has contributed major strength to the recovery. Consumers have stepped up their purchases of big-ticket items, such as automobiles and appliances, putting the economic recovery on a much more solid footing than it was in earlier stages. At the present time, the main weak spot is plant and equipment spending which has failed to show any clear-cut signs of an incipient upturn. Although demand for these investment goods remains weak, the index of leading indicators continues to signal further expansion in the near term.

Inflation has slowed markedly at both the retail and wholesale levels in recent months. Consumer prices rose at a 1.4 percent annual rate in February, the lowest inflation rate in over four years. Wholesale prices were also a source of favorable news, as they increased only slightly in March and remained below December levels. To some extent, however, the recent moderation in inflation has reflected declines in the prices of food and energy items, and it would be overly optimistic to extrapolate the recent experience far into the future. Nevertheless, inflation rates well below the double-digit level appear in prospect.

## INDUSTRIAL PRODUCTION AND INVENTORIES

During February, the Federal Reserve Board's index of industrial production registered a 0.5 percent increase, the tenth consecutive monthly advance. The February rise was fairly broadly based across industry and market groupings, an encouraging sign that the economic recovery is now on a solid footing. While industrial production in February stood 9.3 percent above the cyclical trough, it still has a way to go before the ground that was lost in the recession is fully recovered. Even at recent robust rates of advance, industrial production would not reach its November 1973 peak until early 1977. In fact, only in the nondurable consumer goods sector has the pre-recession peak in output been exceeded.

The automotive sector contributed substantially to the industrial output rise of February, and the available information suggests that a strong gain also occurred in auto output in March. Auto assemblies were up 200,000 units from the improved February level, reaching an 8.3 million unit seasonally adjusted annual rate in March. In recent months the automotive industry has experienced a dramatic improvement in demand from the depressed level earlier in the recovery. Sales of domestic automobiles, which had been essentially flat from late July to November, have picked up considerably since then. Indeed, in February and March, unit sales of domestic automobiles averaged 8.75 million at an annual rate. This represents a 15 percent advance over November and is the highest sales rate since August 1974. While auto manufacturers have stepped up production by a sizable amount, the increase has not been large enough to match the expansion in sales and auto inventories have declined. According to industry sources, an inventory stock equal to about 60 days' supply is regarded as the minimal reserve for the spring selling season. Inventories have been drawn down well below this level, reaching about 50 days' supply at the end of March. It is, therefore, no surprise that the automobile manufacturers reportedly plan to boost their production in the next few months, especially for the larger car models which are in particularly short supply.

In other industries as well, inventory building is likely to be a source of upward thrust in the near future. By the end of last year, it seemed that most businesses had run down their once excessive inventories to the point where further reduction might have resulted in interruptions in the productive process as well as in delays on deliveries of finished goods. Indeed, some analysts asserted that the

declines in November and especially in December were unintended, resulting from unexpectedly strong sales. Recent data suggest that some rebuilding of stocks has begun. The book value of business inventories increased $1.2 billion in January, as gains were recorded in the wholesale trade, retail trade, and manufacturing sectors. Yet, despite the sizable accumulation, the inventory-sales ratio declined further to a level which is low by historical standards. February data for the manufacturing sector indicate that nondurables manufacturing inventories continued to increase, while the change in durables manufacturing inventories turned positive for the first time in a year. The February accumulation was modest, however, and inventory-sales ratios decreased further in both durables and nondurables manufacturing, as shipments continued to advance rapidly. As a result, substantial further inventory accumulation is likely to be necessary to bring stocks to a comfortable level.

## NEW ORDERS AND LEADING INDICATORS

Led by a 28.8 percent surge in orders for automotive equipment, new orders received by durable goods manufacturers spurted 7.4 percent over the three months ended in February. Orders for nondefense capital goods exhibited a modest 1.1 percent advance over the same period, however, and new orders for machinery and primary metals have shown only moderate momentum. The lag of new orders in these industries is important because past movements in new bookings have tended to be fairly reliable advance indicators of changes in economic activity.

The Commerce Department's composite index of leading indicators has resumed its advance following last fall's sluggish performance, which had caused considerable apprehension. The index has increased 3 percent since November. Eight component series rose, contributing to February's 0.8 percent gain, while three components fell. Though the February increase was well below the revised 1.5 percent January spurt, the recent performance of the leading indicators provides corroborating evidence of a near-term continuation of the recovery.

## PERSONAL INCOME AND RETAIL SALES

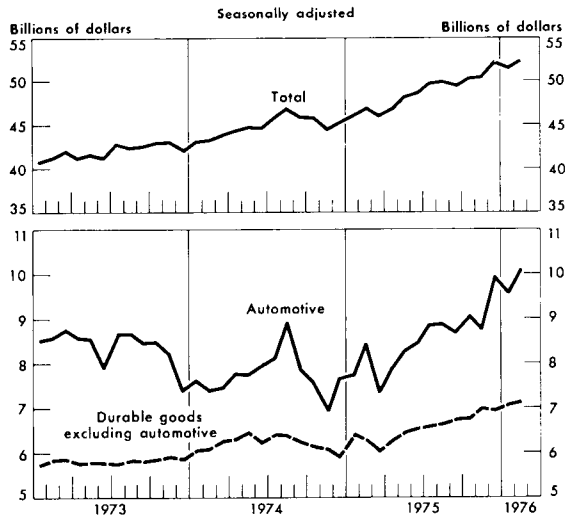
In February, personal income rose $12.9 billion, a slightly smaller gain than in the preceding month but one well above that averaged in 1975. A part of the February increase was attributable to a speedup in certain veterans' benefits, as well as to the receipt of a Federal earned income tax credit (for calendar 1975) by some low-income households with dependent children. Wage and salary disbursements also continued to climb, although the advance was somewhat smaller than in prior months. Over the last three months, wages and salaries have increased at a robust 11 percent annual rate.

The quickening pace of consumption spending that occurred at the end of last year has carried over into the current year. Retail sales had shown comparatively little growth from July to November but have risen strongly since then (see Chart I). In February, total retail sales increased $0.8 billion and were 4.1 percent above the November level. Though the recent gains have been widespread among the major spending categories—nondurable and durable goods—the rise in spending for durable goods has been most marked. Since November, retail durable sales have advanced 9.3 percent. Looking ahead to coming months, further gains in consumption spending would appear to be in the offing. The unemployment picture has brightened considerably, as has the economic outlook in general. Moreover, the heady advance in the stock market in recent months has substantially restored the wealth positions of many consumers. These favorable developments may facilitate future sizable increases in consumption outlays, particularly for durable goods. Indeed, according to the latest surveys, there has been a sharp rise in consumer confidence, which is usually associated with willingness to spend.

Chart I

RETAIL SALES

Seasonally adjusted




Source: United States Department of Commerce.

## RESIDENTIAL CONSTRUCTION AND CAPITAL SPENDING

Residential construction activity reportedly rose sharply in February, as housing starts spurted ahead 27 percent on a seasonally adjusted basis. The previous three months had shown declines. It has been suggested, however, that the huge February increase may have been overstated due to the application of standard seasonal adjustment procedures. February is typically a cold and wintery month in which residential construction is rather low, so that the reported number of starts is blown up to get seasonally adjusted housing starts, an estimate which eliminates the usual impact of weather in February and permits comparison with other months. This February, however, the weather was unusually mild in the colder regions of the country and construction occurred at an unusually high rate for that time of the year. Hence, for this February, the usual seasonal factor for housing starts resulted in too high a level of seasonally adjusted starts, thus accounting for the appearance of a February spurt. To the extent that construction slated for the spring months began early, housing starts in coming months will tend to be somewhat lower than otherwise. Nevertheless, the outlook for residential construction continues to improve. Permits to build new housing units advanced 13.3 percent during the first two months of this year. The recovery in this sector has been dramatic, with permits up about 60 percent from their low point of a year ago.

Demand will probably improve further, as personal income continues to rise and fears of layoff recede. In the Federal National Mortgage Association April 5 auction, both government-underwritten and conventional mortgage rates declined. Conventional mortgage rates fell from their October peak of 10.02 percent to 9.05 percent in April, while government-underwritten mortgage rates dropped 1.01 percent over the same period. These factors may contribute to housing demand during coming months.

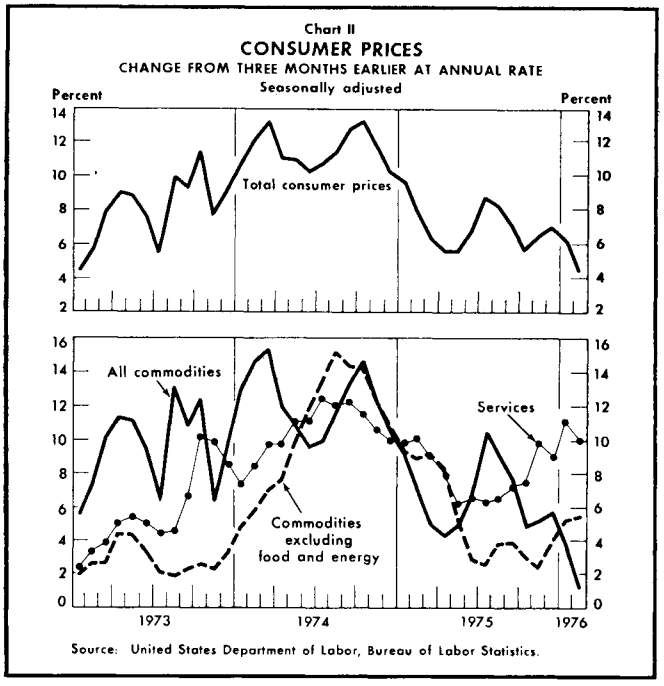
Business fixed investment appears unlikely to contribute much stimulus in the near term. At present, business firms possess substantial excess capacity. Indeed, the current large overhang of excess productive capacity appears to be the principal factor underlying the pessimistic response obtained by the recent Commerce Department survey of planned plant and equipment spending. The latest survey, conducted during January and February, indicates that planned business fixed investment expenditures for 1976 will be 6.5 percent above 1975 levels. Different sectors exhibit a wide divergence in spending plans. The public utilities plan a 15.4 percent increase in plant and equipment spending, while transportation industries (rail, air, etc.) plan sizable cuts in investment expenditures. The scheduled increase in the manufacturing sector is 8.1 percent—stronger than the total—due to the rapid planned advance of capital spending by the nondurables producers. Overall, however, if this survey is accurate, capital spending in real terms is likely to be up only slightly, if at all.

In interpreting the outlook for business capital spending, several other points are worth noting. First, low capital spending is common in the early part of a recovery. Typically, production strengthens because of increasing demand, and then firms decide to expand capacity. Moreover, many firms tend to underpredict the growth of sales during an upturn and therefore underestimate their capacity requirements. Second, the high backlog of unspent appropriations suggests that there could be a very short lead time to capital spending once businesses decide to go ahead with investment. Third, the costs of financing investment are down. Internally generated funds have exhibited a recent surge and, according to the McGraw-Hill survey, pretax business profits are expected to increase an additional 18 percent in 1976. Equity financing opportunities have been enhanced by the recent rise in stock prices. And last year's worries concerning the possibility that Treasury borrowing would crowd out private investment financing seem to have been largely dispelled. Indeed, the interest rate on long-term debt is now slightly lower than at the recession trough.

## PRICES

At both the wholesale and retail levels, inflation has moderated in recent months, in large part because of reduction in food and energy prices. Wholesale prices edged up in March following declines in the previous two months. Prices of farm products and processed foods and feeds were down slightly after four months of sizable drops. With retail food profit margins rather high, some further declines in consumer food prices are likely. Wholesale prices of industrial commodities advanced at a 4.7 percent annual rate which brought the average rate of increase in the first quarter of 1976 to 3.6 percent, a marked improvement from the last half of 1975.

Consumer prices rose a modest 0.1 percent in February, the best monthly performance in over four years. Overall, the performance of the consumer price index during recent months has been quite encouraging (see Chart II). A good part of the recent slowdown in prices, however, is attributable to declines in food prices—a volatile component which is usually not indicative of general price trends—and to declines in energy prices,




resulting in part from recent legislation. Excluding these items, the past three months' experience is somewhat less favorable. For example, consumer commodity prices other than food and energy increased at a rate of 5.5 percent per annum during the three months ended in February, and prices for services advanced at a 10 percent annual pace over this interval. While the favorable behavior of wholesale prices probably augurs well for the consumer price index in the near term, over the longer term inflation may well be more of a problem. One concern is the rate of wage increase over the coming year. The calendar of scheduled union contract negotiations is quite heavy for 1976, and the terms in the new contracts will have an important impact on overall labor costs.

## LABOR MARKET CONDITIONS

Labor market conditions continued to improve in March. Reflecting the trends in production and sales, nonagricultural employment increased by 191,000, its ninth consecutive month of gain, and the rate of unemployment edged down further to 7.5 percent. The March unemployment drop was quite small, as 264,000 new workers entered the labor force looking for work. The extent and duration of joblessness have fallen dramatically. Since last May, employment gains have far outstripped labor force growth, reducing the number of unemployed workers by 1.2 million. Moreover, in recent months, there has been a sharp drop in the number of persons reporting extended unemployment of more than fifteen weeks' duration. Only 2.4 percent of the labor force had been unemployed for fifteen weeks or longer, according to the March survey, compared with 3.3 percent in December.

Improving employment conditions appear to be drawing previously discouraged persons into the work force. In the third quarter of 1975, the Labor Department estimated that 1.2 million such discouraged workers had decided not to search for jobs, despite desiring work, because they believed no jobs were available; in the first quarter this number averaged 0.9 million. With sales continuing to expand, further employment gains appear certain during coming months. If labor force growth picks up in response to improved employment prospects, however, the unemployment rate may tend to recede more slowly in coming months than it has since May.

# The Business Situation

Economic activity in the United States has risen at a brisk pace in recent months. Real gross national product (GNP) advanced at a robust 7.5 percent annual rate in the first quarter, marking the fourth consecutive increase since its low point in early 1975. A major impetus to the economy's first-quarter growth was provided by consumers who bought substantially larger quantities of various goods and services, sharply increasing their purchases of new cars. In addition, a sizable thrust was provided by a turnaround in inventory investment, as businesses began to replenish their stock of inventories. Looking toward the future, many economists expect residential construction activity to pick up further as employment increases and consumer incomes continue to rise. Moreover, it is unlikely that there will again be a sharp deterioration in the net export position, as occurred in the first quarter when the United States upswing outpaced that in other countries. Changes in conditions in the labor market during the first quarter reflected the rapid expansion in the level of production. Compared with the previous quarter, about ¾ million more workers held jobs in the nonfarm sector and the unemployment rate dropped almost a full percentage point. Employment showed further strong gains in April but, due to a large increase in the size of the labor force, the unemployment rate remained at 7.5 percent. Other indicators of labor market conditions such as the average duration of unemployment, however, have continued to improve.

Accompanying the first-quarter rebound in economic activity was an unexpectedly dramatic deceleration in the rate of increase in prices. The GNP implicit deflator, the broadest measure of prices in the economy, rose at the lowest rate in nearly four years. Moreover, the behavior of the wholesale and consumer price indexes confirmed the marked slowing in inflation. Most of the recent decrease in inflation, however, resulted from drops in food and energy prices. Since these declines are not expected to continue, some acceleration in the rate of inflation would seem likely over the near term. Indeed, at the wholesale level, April data show a sizable increase in farm prices. Nevertheless, worries about a possible return to the inflation rates seen in 1974 have largely disappeared. From a somewhat longer term perspective, the rate of wage gain is important for the price outlook. Some of the recent news on wage increases has been mildly encouraging, but most of the major wage contracts scheduled for 1976 have yet to be negotiated.

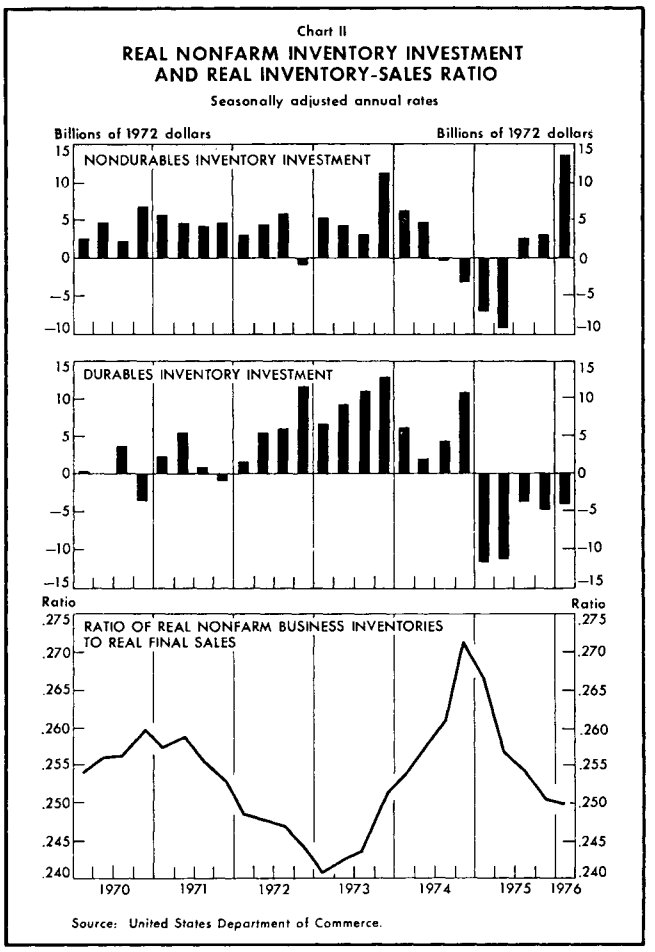
## GNP AND RELATED DEVELOPMENTS

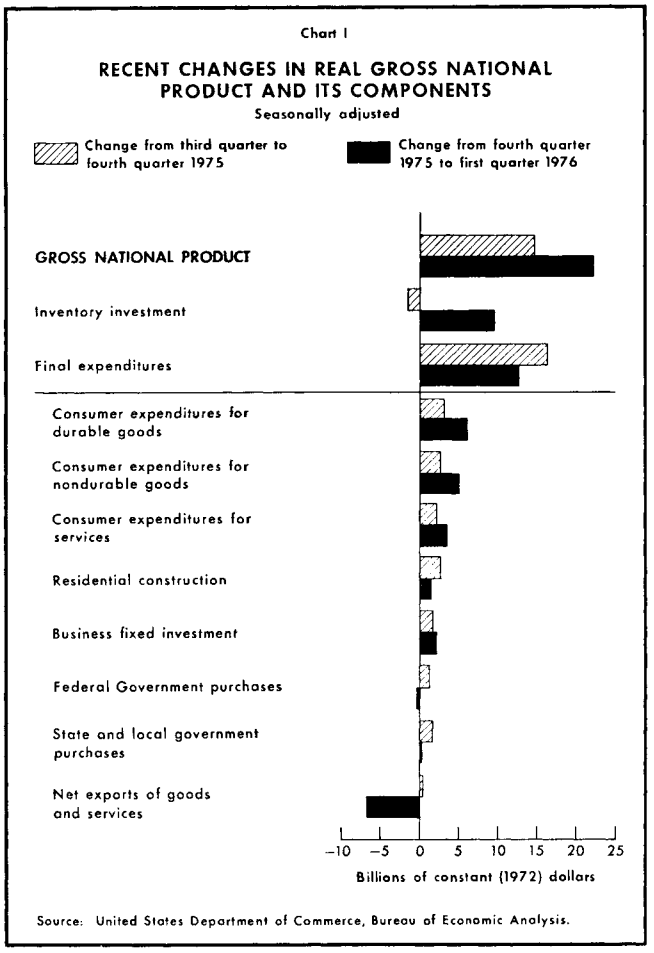
According to preliminary estimates, output of final goods and services in physical terms increased at a rather sharp 7.5 percent annual rate during the first quarter. This solid advance marked the fourth consecutive gain in real output and dispelled remaining doubts about the sustainability of the recovery. The level of economic activity has now regained almost all of the ground lost in the steep recession. However, since both the labor force and capacity have grown in the interim, the potential level of output is well above the current level, leaving room for further sizable increases in production. The first-quarter expansion largely reflected a sharp increase in inventory investment and a sizable advance in consumer purchases of both durable and nondurable goods and services. Although most other components also showed gains (see Chart I), net exports declined.

In the first quarter of this year, many business firms began to refurbish their depleted stocks of inventories and the swing from liquidation to accumulation accounted for half of the growth in real GNP. The Commerce Department's preliminary estimates, which are based on incomplete inventory data, indicate that the shift toward accumulation was attributable to businesses which produce nondurable goods (see Chart II). It appears that the excessive inventories held by producers of nondurables in 1974 had been worked off by the end of 1975. In fact, in some industries producing nondurable goods, modest accumulation had begun in the second half of 1975. It is not surprising that the nondurable goods sector, which was the first to begin liquidation of excess stocks, would be the earliest to resume inventory accumulation. In contrast, firms manufacturing durable goods began their inventory reductions somewhat later, and

liquidation continued into the early part of the first quarter. The latest monthly data, however, indicate that in February and March durables manufacturers began to build inventories once again. As a result of the massive inventory reduction during 1975 and the pickup in final sales, the overall ratio of inventories to final sales has declined significantly and, by the first quarter of 1976, the ratio of nonfarm business inventories to final sales had fallen close to pre-recession levels. With inventory stocks now at a fairly comfortable level, inventories will have to grow at about the same rate as sales for firms to have large enough stocks of materials, goods in process, and finished goods to operate efficiently.

Consumer spending, which has provided the major stimulus in the upturn, continues to contribute strength to the rebound of production. In the first quarter, consumer purchases of goods and services in real terms advanced at a 7.5 percent annual rate, the largest rate of increase posted since late 1972. Much of the recent surge in consumption has been accounted for by the rebirth of buyers' interest in new cars. Unit sales of domestic models rose to an average of 8.7 million in the January-March period, about 10 percent above the average sales in the final quarter of 1975 and some 22 percent over 1975 as a whole. In April, sales of domestic cars advanced again, reaching a seasonally adjusted 9 million unit annual rate. The resurgence of auto demand has been primarily for standard- and intermediate-size domestic models. The industry, having misjudged the demand mix this year, is apparently near capacity production of these models, and the inventories of autos, which overall are now low relative to sales, are reportedly even lower for these suddenly popular models. Sales of the generally smaller imports, on the other hand, have been very



sluggish, holding steady at an annual rate of 1.3 million units, and their share of total United States auto sales has ebbed to about 13 percent, down sharply from the over 20 percent share they had early in 1975. While the resurgence in automobile demand shows every sign of continuing, a production bottleneck could conceivably arise this summer, if the United Rubber Workers' strike against the tire producers becomes prolonged. Automakers say their stocks of rubber-related products could sustain production for only several weeks.

The pickup in sales of autos and other big-ticket items provides tangible evidence of improving consumer confidence. The slowing of inflation, recovery in employment and incomes, and the rebound of equity prices all have fostered a more optimistic outlook and have encouraged spending. The consumer sentiment index of the University of Michigan jumped sharply in the first quarter and now stands close to the level reached before its plunge during the recession-inflation environment of 1974-75.

Undoubtedly, the improvement in consumer sentiment has also played a role in the demand for new houses. Residential construction activity increased at an annual rate of 14.4 percent in the first quarter of 1976. Moreover, since work on new housing units continues for several months and is typically heaviest in the three months after the unit has been started, the recent rate of housing starts and new permits issued suggests that further gains can be expected in the second quarter of this year. Housing starts rebounded sharply in February and remained close to this higher level in March. At 1.44 million units annually, housing starts in March were more than 50 percent above their low point in early 1975. Nevertheless, the industry is operating far below its pre-recession level, with construction of multifamily dwellings particularly depressed. Multifamily housing starts (each apartment is counted as a unit) fell substantially during the first quarter, though several factors suggest that building may strengthen during coming months. Permits for new units, particularly multifamily units, showed gains in the first quarter. In addition, the rate of absorption of new units has picked up recently. Mortgage commitments at savings and loan associations, one of the leading indicators of future building activity, have risen 4.4 percent since the final quarter of 1975, reaching their highest levels since mid-1973. In general, the current and near-term outlook on mortgage money availability is favorable, as savings and loan deposit flows have remained high.

Though business investment in fixed capital remains well below its previous peak, there was a significant increase in real expenditures on business equipment and structures during the first quarter: business fixed investment in real terms grew at a 7.7 percent annual rate. Surveys of planned plant and equipment expenditures carried out earlier in the recovery had indicated that little or no growth in real expenditure could be expected during 1976, but some of these surveys did predict a first-quarter surge. The McGraw-Hill spring survey shows that firms have revised upward spending plans, and other new surveys may show upward revisions as a result of a brighter outlook for demand and improved financial conditions. The early months of 1976 saw rising equity prices, coupled with moderating long-term interest rates, and a resurgence of internally generated funds. With the economy's solid performance reducing many uncertainties about future demand, the likelihood of an advance in capital outlays appears to be improved. Although capacity utilization rates remain relatively low in most industries, firms may begin to undertake modernization expenditures. During the past few years, the types of equipment and structures that business firms find best suited to their needs have been radically altered by the changing relative price of energy as well as by the impact of environmental legislation. It has been argued that firms' responses to these changing conditions were delayed by the recession and that the next few years may find them modernizing their stocks of plant and equipment, thus adding to investment demand.

The sharp deterioration in net exports in the beginning of 1976 reflected a surge in imports at the same time that exports declined. The strong rise in imports was largely attributable to the rapid expansion in economic activity and personal incomes in the United States which increased the demand for all types of goods and services including those produced abroad. In explaining the fall in exports, some analysts point to the fact that the timing of grain shipments to the Soviet Union accounted for some of the declines and that much of the remaining fall was concentrated in the highly volatile civilian aircraft and parts category. Others note that last summer's appreciation of the dollar may have contributed to the decline in exports as well as to the strong rise in imports. Looking to the near future, there are some indications that economic growth of some of the major American trading partners is picking up. This coupled with a more normal rate of expansion in the United States makes it unlikely that further sizable declines in net exports will occur.

Government purchases of goods and services contributed little to the latest rise in aggregate demand. Federal expenditures actually edged down in real terms, as the increase in nondefense expenditures failed to offset the decline in defense spending. The latest information on orders for defense goods indicates that defense spending is

likely to be up in the near future so that the level of Federal spending will probably be more stimulatory in coming months. At the state and local levels, spending increases were substantially smaller than in the final quarter of 1975. Apparently reacting to taxpayer resistance to higher levies, state and local payroll employment grew at less than one third of its recent rate. With long-term financing costs high and voter resistance to new bond issues widespread, municipal construction dropped.

As personal incomes are continuing to grow rapidly and the outlook for business expenditures is brightening, there now seems little doubt that the recovery will persist.

## PRICES

By virtually every broad measure of price change, inflation has slowed markedly in recent months. As measured by the implicit GNP price deflator, prices of goods and services advanced at a 3.7 percent annual rate in the first quarter, down sharply from the 6.8 percent increase recorded in the previous three-month period and the 8.8 percent rise in 1975 as a whole. The rate of growth of the fixed-weight price index for GNP—which, unlike the GNP deflator, is unaffected by shifts in the composition of output—also showed a sharp deceleration. The fixed-weight deflator rose at an annual rate of 3.9 percent in the initial quarter of 1976, compared with 7.2 percent in the final quarter of 1975.

Consumer prices, as measured by the overall consumer price index, increased at a moderate 4.5 percent pace on a quarterly average basis during the first quarter, compared with a 6.5 percent rate of increase in the fourth quarter of last year. The first-quarter rate of inflation was the lowest recorded since the end of 1972. A closer look at the behavior of the components, however, suggests that temporary factors helped to retard inflation in recent months. During the first quarter, food prices declined for the first time in more than eight years, falling at an annual rate of 2.4 percent. At the same time, consumer energy prices dropped at a 5.4 percent annual rate, reflecting in part the impact of recent legislation. Excluding these items, the behavior of prices has been less favorable. The price of consumer services rose at a 10.5 percent annual pace, while the prices of commodities other than food and energy grew at a 5.4 percent rate. While inflation has cooled significantly from its 1974 rate, the magnitude of price increases for services and commodities other than food and energy during recent months makes it clear that the underlying trend rate of inflation remains above the first-quarter experience. If, as widely expected, the outright declines in food and energy prices are replaced by modest increases, the overall rate of inflation will certainly accelerate in the near term. Such movements will not signal an increase in the trend rate of inflation but rather the absence of large, temporary rates of decline in the prices of food and energy.

In April, wholesale prices of farm products and of processed foods and feeds rose 2.8 percent, thereby recovering half the decline of the past five months. This turnabout caused the overall wholesale price index to rise 0.8 percent despite the sustained decline in power and fuel prices, which fell 0.4 percent. The wholesale prices of industrial commodities continued to advance, climbing a relatively moderate 0.3 percent in April. During the first four months of the year, wholesale industrial prices rose at an annual rate of less than 3½ percent, down substantially from the 9.2 percent rate in the last half of 1975. The surge in prices of farm products and of processed foods and feeds in April suggests that the slide in retail food prices is probably near an end. Wholesale prices of consumer goods other than food, however, edged down in April for the second consecutive month. This development suggests a near-term continuation of relatively modest rates of increase in consumer prices of goods other than food.

## WAGES, PRODUCTIVITY, AND EMPLOYMENT

The recent data indicate that there was some moderation in wage pressures in the early months of 1976. The average hourly earnings of private nonfarm production and other nonsupervisory workers, adjusted to exclude the impact of interindustry shifts and of overtime in manufacturing, rose at a 6.2 percent annual rate during the first quarter, the smallest quarterly increase in the last three years. And the first-quarter major collective bargaining settlements indicate a slight reduction in the rate of increase of wages and benefits. The average first-year wage and benefit gain negotiated in the first-quarter settlements covering 5,000 or more workers was 9.5 percent, down from last year's 11.4 percent increase, and the teamster settlement reached in April, which covered 450,000 workers, called for a first-year increase in wages and benefits of slightly over 9 percent. To be sure, a substantial part of the 4.2 million workers whose contracts are slated to expire in 1976 have yet to negotiate new agreements, so that bargains struck in the coming months will be more important for overall wage costs. There are a few signs that these wage increases may be moderate. High unemployment in some sectors has apparently altered several unions' bargaining strategy. For example, in the depressed construction industry, wage increases have been moderate and,

indeed, a few unions have even accepted pay cuts in order to be more competitive with nonunion workers. In addition, the United Auto Workers, who are involved in the largest settlement of the year, have announced that job security rather than wage increases will be the primary bargaining issue.

Productivity, as measured by output per hour worked in the private nonfarm economy, increased at a 3.3 percent annual rate in the first quarter of this year after declining in the fourth quarter of 1975. Over the last four quarters, productivity has risen at a rapid 4.9 percent rate. Increased productivity usually occurs at the beginning of an economic upturn, so that the recent pattern was expected. The brisk increase in productivity, coupled with moderate increases in labor compensation per hour worked, has greatly reduced cost pressures. Over the four previous quarters, unit labor costs in the private nonfarm economy rose just 2.4 percent.

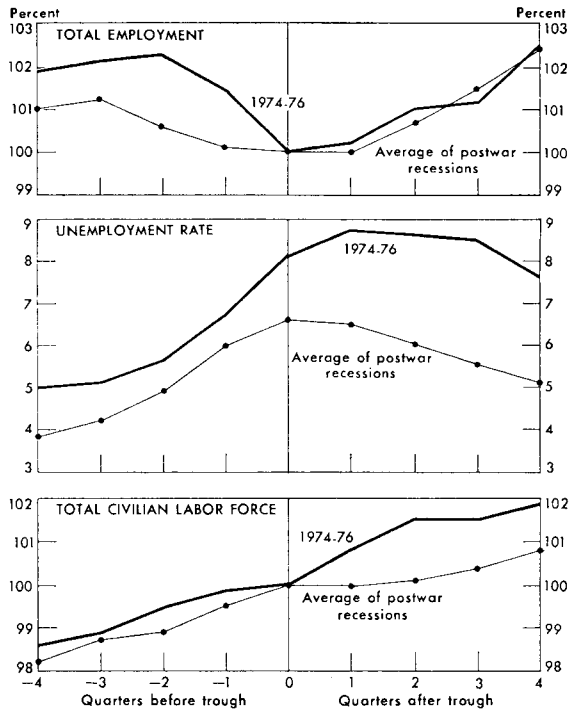
The rapid upturn of economic activity has resulted in a marked increase in employment. Compared with the final quarter of 1975, ¾ million additional workers were employed in the nonfarm sector. Some had been recalled from layoff, and others had found new jobs. This led to a dramatic 0.9 percent fall in the percentage of the labor force who were unemployed. In April, labor market conditions overall continued to improve. Nonfarm payroll employment climbed by 350,000 persons, as most sectors of the economy expanded their work forces. According to the survey of households conducted monthly by the Bureau of Labor Statistics, total civilian employment rose 700,000 in April. A roughly equal spurt in the civilian labor force prevented the strong employment gains from being reflected in the unemployment rate, which remained at 7.5 percent. However, other measures did show further improvement in labor market conditions. For example, the percentage of the labor force unemployed for more than fifteen consecutive weeks fell another 0.2 percentage point, continuing the sharp decline in extended unemployment that began in January.

The conditions in the labor market over the course of the recent downturn and recovery have been somewhat different from the experience in other recessions (see Chart III). Early in the downturn, many firms felt that the decline in economic activity would be mild. They therefore retained a relatively large fraction of their work force and maintained production, allowing inventories to build up. Thus, early in the recession, employment held up well when compared with typical postwar recession experience. Then, as events made it clear that a sales recovery was not going to materialize as quickly as expected, firms found themselves faced with a massive overhang of undesired inventory and they began layoffs, causing employment to drop rapidly. Since its low point in the first quarter of 1975, however, the recovery in employment has been very similar to typical postwar recession experience. In the early part of previous recoveries, however, high unemployment rates induced a falloff in the rate of labor force growth. This phenomenon appears to have been largely absent during the recent cycle. It is not clear why labor force growth has remained so strong. Perhaps the decline in real wages that many nonfarm wage earners experienced led additional family members to seek jobs, or maybe extended unemployment benefits have kept individuals in the labor force who would otherwise have dropped out in discouragement. In any event, the large increase in the size of the work force in this recovery has meant that the unemployment rate has fallen more slowly than it had in past postwar upturns.

Chart III

**THE LABOR MARKET IN RECESSION AND RECOVERY**

**INDEXED AS A PERCENTAGE OF TROUGH-QUARTER LEVEL***




Note: The National Bureau of Economic Research-dated recession troughs occur in fourth quarter 1949, second quarter 1954, second quarter 1958, first quarter 1961, fourth quarter 1970 The trough quarter for the latest recession has not yet been dated by the NBER. The first quarter of 1975 was selected as the tentative trough quarter.

*For each reference cycle the trough-quarter level equals 100 percent.

Source: United States Department of Labor, Bureau of Labor Statistics.

# The Business Situation

The recent business figures point to a continuation of the economic advance, though some indicators suggest some slowing from the exceptionally strong first-quarter rate of increase. The first-quarter gain in real gross national product (GNP) is now estimated at an 8.5 percent annual rate, 1 percentage point higher than indicated in the initial report. In April, industrial production showed another sizable gain, and total employment rose substantially in both April and May, bringing the overall unemployment rate down to 7.3 percent. In the consumer area, however, retail sales apparently flattened in April after large earlier gains and auto sales edged back a bit in May. Somewhat inexplicably, some reports also suggested a setback in consumer confidence this spring after major earlier improvements. Housing starts and permits also declined in April, indicating an interruption, however brief, in the revival in housing which most analysts expect to resume over the balance of the year. In the capital spending area, the new spring Government survey suggested only a slightly more vigorous rise than was indicated last winter and left somewhat uncertain the amount of expansion that could be expected in real terms this year. Thus, on balance, the recent business news has been somewhat more mixed than in the first quarter, when the gains posted were so sizable and so nearly universal that doubts began to be expressed as to whether the expansion would continue on the generally moderate and reasonably well-balanced course it had followed through most of its first year.

The news on the inflation front has continued to be generally favorable. To be sure, farm and food prices rebounded in April after several months of decline. Prices of nonfood commodities, however, continued to rise only moderately at both the wholesale and the retail levels. In May, wholesale prices of industrial commodities were virtually unchanged. During the past six months, these prices have risen at an annual rate of barely 3½ percent, and retail prices of nonfood commodities rose at the same rate over the six months ended in April. Somewhat more rapid price increases could well occur in coming months, however, since posted increases in the prices of a number of basic commodities have yet to take effect. In addition, unit labor costs have been held down by the combination of cyclical improvements in productivity and relatively moderate wage increases. For example, during the six months ended in May, average hourly earnings of production and nonsupervisory workers, adjusted for the effects of interindustry shifts of employment and of overtime in manufacturing, rose at an annual rate of only 6 percent. The bulk of this year's relatively heavy calendar of collective bargaining settlements still lies ahead, and somewhat larger overall wage increases would not be surprising. On balance, however, recent and prospective developments give little indication of a change in the underlying rate of inflation, which appears to be running in the neighborhood of 6 percent.

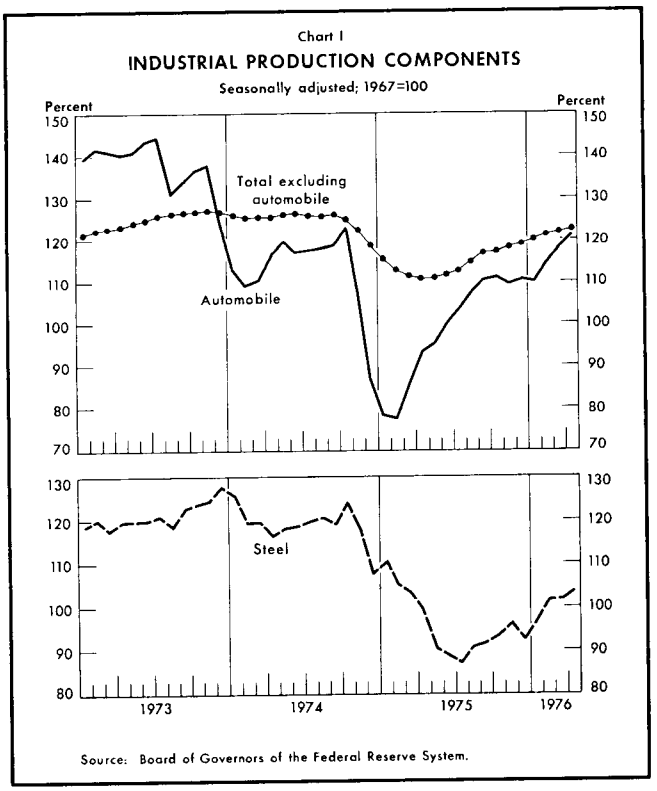
## INDUSTRIAL PRODUCTION, ORDERS, AND INVENTORIES

The Federal Reserve Board's index of industrial production—which measures the physical volume of output of the nation's factories, mines, and utilities—rose 0.7 percent in April. At the same time, upward revisions were made in the estimates for industrial output for the two preceding months. Since its low point in April 1975, the index has advanced 11.5 percent, recovering nearly three quarters of the ground it had lost during the recession. In recoveries from previous postwar recessions, industrial production advanced about 16 percent on average in the twelve months after the trough, somewhat faster than the current experience. Moreover, in these previous upturns, industrial output had typically exceeded its previous peak value after twelve months of recovery while real GNP usually exceeded its previous peak within three quarters after its trough. By these standards, the current recovery, although brisk, is by no means extraordinarily rapid.

Although output expanded in most industrial sectors in the past year, the rate of gain has not been uniform. Manufacturers of nondurable goods have increased their rate of production fairly steadily since the recession trough, providing major strength to the recovery. In contrast, the pattern in durables industries has been

more uneven. Early in the recovery and again in more recent months, auto production provided a major impetus to the upturn in economic activity (see Chart I). Although auto sales are typically quite responsive to the general state of the economy, the recent fluctuations have been unusually large. Between March 1973 and April 1975, the peak and trough of the latest automobile cycle, sales of domestic-model cars dropped 46 percent whereas, on average, auto sales declined only 30 percent in other postwar downturns. Recalling that gasoline prices have risen substantially since the end of 1973, it is not surprising that auto sales suffered more than would usually be expected in an economic downturn. The change in energy prices also opened the possibility of a marked shift in life-styles, and earlier in the recovery it was unclear whether auto demand in particular would return to previous levels when real incomes had fully rebounded. However, sales have recovered not only much of their lost ground but also much of their former pattern, with demand concentrated in larger size models.

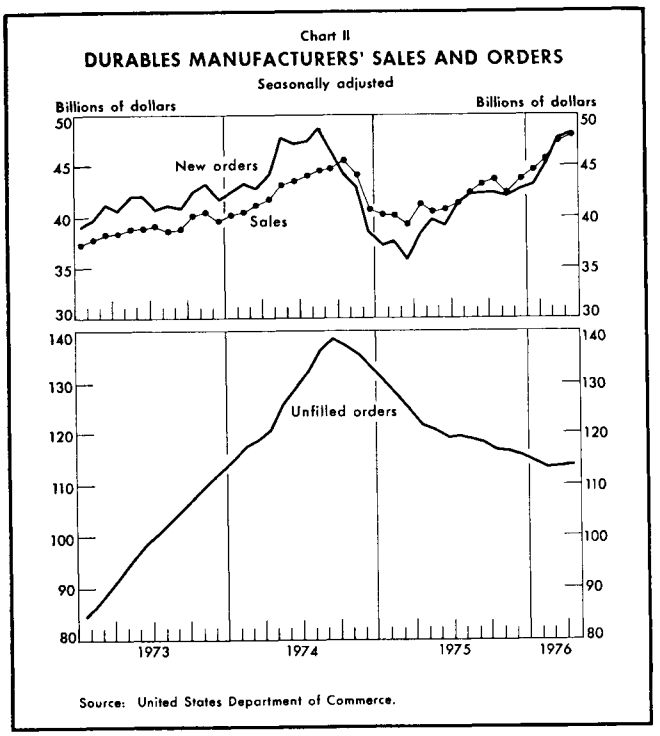
In April, new car purchases occurred at a 9 million unit annual rate, nearly 60 percent above the level of one year earlier. The latest data indicate that sales slowed to an 8.5 million unit annual rate in May. The recent pace of demand resulted in lower than normal inventories of many models and, to rebuild stocks, automakers expanded production for the fourth straight month, bringing auto assemblies to an 8.7 million unit rate in May.




The rapid increase in auto production since the beginning of 1976 has been an important factor in the rising demand for steel. Output in the steel industry rose by 14.5 percent during the first five months of the year. Steel industry sources report that the quick pace of the increase has brought scattered signs of temporary shortages, although overall capacity appears adequate to meet demand. Steel price increases, announced in May and June for various product lines and effective about one month after the announcement date, may have induced metal purchasers to place orders while they could still benefit from the lower prices. If so, the data on new orders for this industry may show a bulge in May and June and a fall-off during the remainder of the summer.

Output of business equipment has also risen at a fair pace in recent months. During April, production in this sector advanced at an annual rate of nearly 10 percent and reached a level of 7.1 percent above its recent low point. Business equipment production troughed in July 1975, later than overall industrial output, and its rebound began quite slowly. It is common for the production of business equipment to lag other measures of economic activity because the existence of excess productive capacity tends to discourage the purchase of new equipment. The resurgence of demand for new capital goods depends in part on the rapidity with which the general recovery reduces excess capacity. The rebound in output of business equipment has been somewhat less robust than the postwar average, reflecting the depth of the last recession.

The outlook for further production gains, particularly in the business equipment sector, continues to improve. New orders for durable goods on a seasonally adjusted basis rose in April for the fifth consecutive month (see Chart II), led by a surge in orders for machinery. Manufacturers of other types of nondefense capital goods also experienced sizable increases in bookings. Apparently, in the capital-goods-producing sectors, manufacturers have been filling these orders rapidly and there has been no buildup in the backlog of unfilled orders. This may reflect the extent of idle capacity in the business capital goods sector. In contrast, primary metals and transportation equipment manufacturers did find that their order backlogs increased in both March and April. The steel and auto industries, which are part of these two respective sectors, experienced sizable improvements in demand




earlier in the recovery and are probably operating closer to capacity than are capital goods manufacturing firms. Overall, the backlog of unfilled orders for durable goods edged higher for the second month in a row, after declining for most of the period since September 1974.

The increases in orders for capital goods are consistent with the steady upgrading of capital spending plans shown in successive surveys by the Department of Commerce. According to the April-May survey of plant and equipment expenditure plans, nonagricultural businesses anticipate spending 7.3 percent more in 1976 than in 1975, up almost 2 percentage points from the December survey. Even with these latest upward revisions, however, the plans reported in this survey indicate a cautious attitude toward new investments in plant and equipment. While the latest data on capital appropriations by 1,000 large manufacturing firms showed some declines from the last quarter of 1975 to the first quarter of 1976, the backlog of appropriations remains quite high. Consequently, further improvements in business confidence could well lead to increases in the rate of capital spending with little delay.

Although business spending on plant and equipment has been fairly slow to respond to the upturn, business investment in inventories moved up sharply in the early months of 1976. Inventory stocks had been sharply reduced during 1975. Now, with sales and output up strongly, business firms need larger stockpiles to facilitate production and trade. In March, the book value of manufacturing and trade inventories increased $1½ billion, marking the third consecutive month of substantial increase. A large fraction of the rise was accounted for by durable goods manufacturers and retailers who have just lately begun to rebuild their inventories. However, the available data for April, which cover just manufacturing firms, show only a small increase in total inventories, as materials and supplies inventories declined. Work-in-progress inventories, which have only recently begun to rise, continued upward in April. Work-in-progress inventories are commonly large relative to shipments in the capital goods sector, where the duration of the production process is longest. Another factor tending to create work-in-progress inventories is the occurrence of bottlenecks and long delivery lags, which can cause interruptions in the production of goods with rather short production processes. Although purchasing agents have reported some lengthening of delivery lags, apparently there have been few serious problems. Overall, the outlook for further planned inventory increases is favorable. With inventories at comfortable levels relative to sales, both the durables and the nondurables sectors will require additional stocks of inventories as sales expand.

On balance, the outlook for additional gains in economic activity is good. The Commerce Department's composite index of leading indicators rose strongly in April, extending the uptrend that began in March 1975, the tentative trough month. [See "Evaluating the Leading Indicators" in this issue for a discussion of the lead time of this composite index.] This suggests that further expansion in economic activity is in the offing. The April gain of 1.1 percent reflected a sharp rise in the money supply component, although five other components also rose while four components declined. The average workweek of production workers, usually included, was excluded from the April composite index because the coincidence of holidays in the survey week caused the measured workweek to understate typical workweek length.

## PERSONAL INCOME, RETAIL SALES, AND RESIDENTIAL CONSTRUCTION

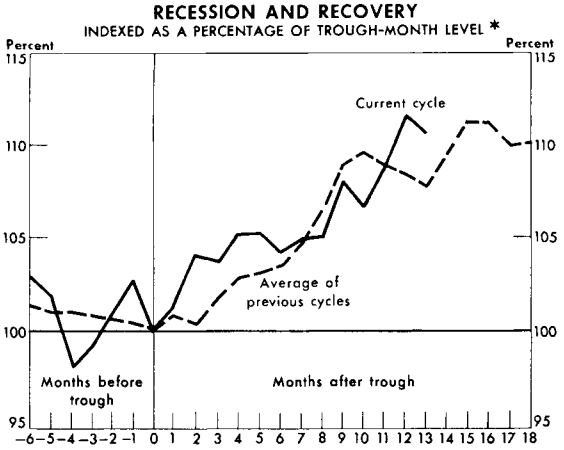
Personal income rose $11.6 billion in April, about equal to the average monthly increase during the first quarter. Wage and salary disbursements accounted for a substantial part of the April increase, growing at an 8.4 percent annual rate during the month, but most other

components also advanced strongly. There is some indication that wage and salary disbursements might have been even higher had not the week of the Bureau of Labor Statistics payroll survey been one in which both Passover and Good Friday occurred. The average workweek was lower because of these holidays, and the usual seasonal factor does not adequately correct when these two holidays occur in the same week. Although a major part of the recent gain in personal income has been attributable to the growth of payroll employment, other components of personal income that are more sensitive to economic activity are beginning to show signs of improvement. For example, dividend payments rose at a 22 percent annual rate.

The improvement in incomes has been reflected in sizable increases in consumer purchases in the past year. Between April 1975 and April 1976, retail sales grew by 13.8 percent. Even allowing for price rises, this is a substantial increase. Typically, in the twelve months after a business-cycle trough, retail sales expressed in constant dollars increase about 8 percent, whereas in the current upturn the volume of sales has risen 10½ percent (see Chart III). The latest data, however, indicate some moderation in consumer buying. According to the advance report, retail sales for April were virtually unchanged at $53.3 billion which, adjusted for price increases, represents a decline in the physical volume of sales. In addition, early reports on weekly retail trade during May suggest that sales were slow until the final week, due in part to unseasonably cool weather in the Northeast.

The most recent data on activity in the housing sector have also been somewhat disappointing. Total private housing starts declined a bit in April. With consumer incomes strong and consumer sentiment much improved earlier in the year, analysts had expected continued gains in residential construction activity. There have been significant gains in single-family housing starts in every quarter since the spring of 1975. In the March-April period, single-family starts averaged 1.1 million, up 43 percent from the level of the corresponding two-month period in 1975. Multifamily starts, however, after rebounding strongly in the last half of 1975, have declined somewhat since then. In the last quarter of 1975 multifamily starts were 53 percent above the March-April 1975 level, but by March-April 1976 they had receded to 42 percent above the year-ago level. There are, however, some signs that the multifamily picture may improve. For example, the rental vacancy rate fell 0.8 percentage point to 5.5 percent from the second quarter of 1975 to the first quarter of 1976. In addition, the outlook for both single and multifamily housing starts is aided by the highly liquid position of the thrift institutions, which have been experiencing large deposit inflows.

Chart III
**CONSTANT-DOLLAR RETAIL SALES IN RECESSION AND RECOVERY**
INDEXED AS A PERCENTAGE OF TROUGH-MONTH LEVEL *




Note: The National Bureau of Economic Research-dated recession troughs occur in October 1949, May 1954, April 1958, February 1961, and November 1970. March 1975 was selected as the tentative trough month for the latest recession.

*For each reference cycle the trough-month level equals 100 percent.

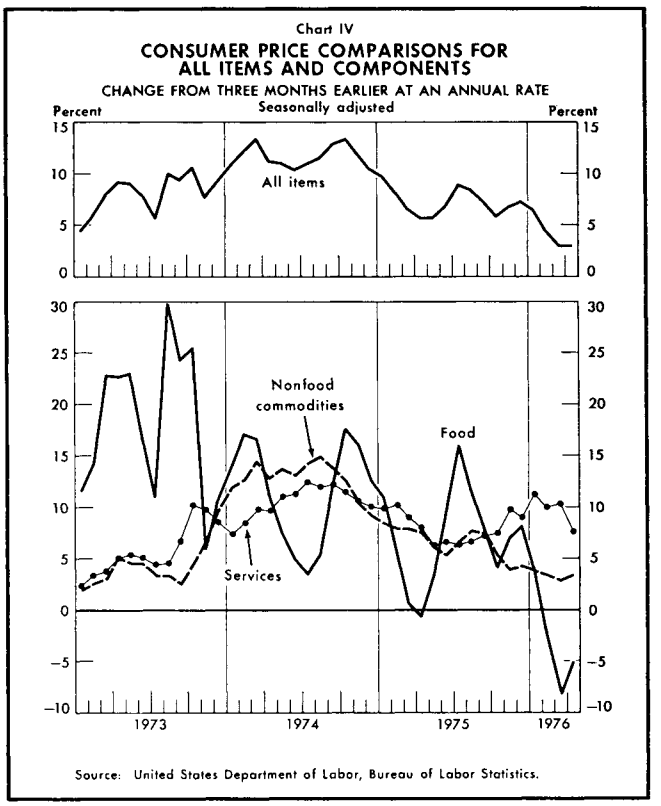
Source: United States Department of Commerce.

## LABOR MARKET

Conditions in the labor market have improved dramatically over the past half year. According to the household survey conducted by the Bureau of Labor Statistics, employment rose by 2.5 million persons between November 1975 and May 1976. There have been substantial gains in payroll employment in virtually every sector over this period, but the greatest expansion has occurred in manufacturing, trade, and services. In May the unemployment rate declined an additional 0.2 percentage point to 7.3 percent of the civilian labor force; since November the rate has dropped 1.2 percentage points.

There has been a steady decline in the number of persons reporting extended unemployment. Those reporting fifteen or more weeks of unemployment comprised less than 2.2 percent of the civilian labor force in the April-May period, compared with 2.7 percent in the first quarter of 1976 and 3.1 percent in the last quarter of 1975. Additional insight on the improved labor market conditions can be gained from the data on labor turnover in the manufacturing sector. The rate of new hires has accelerated in the past few months and averaged 2.8 new hires

per 100 employees in the March-April period, compared with 2.4 new hires per 100 employees in December-January when employment gains were achieved more extensively by the recall of laid-off workers. Moreover, the quit rate—the fraction of employees who voluntarily decide to terminate employment—has risen by one sixth in this interval. The quit rate tends to increase when employees believe there are good job opportunities available.




## PRICES

Although there has been a substantial moderation in the trend rate of inflation during the past eighteen months, movements about this trend at both the wholesale and the retail levels have reflected large swings in farm prices. For example, in the final months of 1975 and the early months of 1976, farm prices were declining and this led to a reduction in the rate of increase in both the wholesale and the consumer price indexes. The situation has now been reversed, as farm and food prices have begun to climb.

At the consumer level, food prices rose in April for the first time in four months, though they are still below the level of December 1975. Most of the recent declines in food costs will probably be reversed in the course of the year. In fact, the Department of Agriculture has said that it expects food prices to rise between 2 percent and 5 percent in 1976. Of course, the actual outcome will depend on the uncertainties of weather both here and abroad. Nevertheless, even food price increases at the high end of the range would represent the smallest rate of increase in four years. Other components of the consumer price index have shown less dramatic movements over the previous year (see Chart IV). The inflation rate for nonfood commodities has moderated over the past year and a half, but part of the deceleration in early 1976 reflected energy price decreases. The recently announced increases in gasoline prices, which are not reflected in the April data, may alter this downtrend. Prices of services have accelerated during the past year, but the rate of increase moderated in April. Overall, few observers expect an early return to the 2-3 percent inflation rate that was seen in several early months of 1976, when food prices fell. On the other hand, few expect a return to double-digit inflation rates even if food prices rise over the year.

At the wholesale level, the prices of farm products and feeds also began to rise in April. This uptrend continued in May, bringing the farm products and processed foods index back nearly to its December 1975 level. Prices of industrial commodities increased by less than 0.1 percent in May, sustaining the improvement seen in the earlier months of 1976. On average, industrial prices have risen at a 2.8 percent annual rate since last December, down substantially from the 9.2 percent annual rate of increase in the second half of 1975.

One constructive element in the price picture has been the behavior of wages, which constitute a major component of the costs of production. Average hourly earnings of production and nonsupervisory employees in the nonfarm sector, adjusted to exclude the effects of interindustry shifts of employment and of overtime in manufacturing, rose at an annual rate of 6.1 percent during the six months ended in May. This was markedly lower than the 8.7 percent annual rate of increase averaged during the 1974-75 period. The moderation of wage increases in recent months has been facilitated by a relatively light collective bargaining calendar. In view of the sizable number of workers involved in new contracts yet to be negotiated during the remainder of the year, it would not be surprising to see some pickup in the rate of wage increase in coming months. Nevertheless, it appears unlikely that a major acceleration of wages will emerge in the near future.

# The Business Situation

The latest readings continue to suggest that the economic expansion has slowed down somewhat in recent months after an unusually sharp first-quarter increase. Consumer spending, which provided a major impetus earlier in the recovery, appears to have weakened for a period during the spring, although the most recent figures suggest that this weakness may well prove to have been temporary. An additional source of slower growth in the second quarter seems to have been a rough leveling-off in the rate of inventory accumulation after this sector had provided a sharp spur to overall growth in the first quarter. The more moderate pace of activity in the second quarter was reflected in a slower growth of industrial production and in a leveling-off of nonfarm payroll employment in May and June. In June, the unemployment rate edged up 0.2 percentage point to 7.5 percent after many months of almost continuous decline. Despite the apparent slowdown of economic growth in the second quarter, the available information suggests that the expansion still has considerable momentum behind it. Indeed, by settling down to a more moderate pace, the expansion may well have improved its prospects for longevity, as well as the prospects for avoiding an early reemergence of capacity pressures in critical industries and resulting upward pressures on prices.

The immediate price situation, to be sure, does not look as good as it did a few months ago, when food and fuel prices were undergoing temporary declines. With recent advances in food prices and with some renewed upward movements in prices of major fuels, the incoming data look less favorable. Nevertheless, a careful reading of the latest price figures does not, on balance, indicate that the underlying rate of inflation has accelerated. For example, consumer prices excluding the volatile food and fuel components rose at a bit over a 5 percent annual rate in May, and wholesale industrial prices over the first half as a whole rose at a surprisingly moderate 3.4 percent rate. Moreover, while second-quarter labor cost data are still incomplete, the rise in average hourly earnings continued at well below the rapid 1974 and 1975 rates of increase.

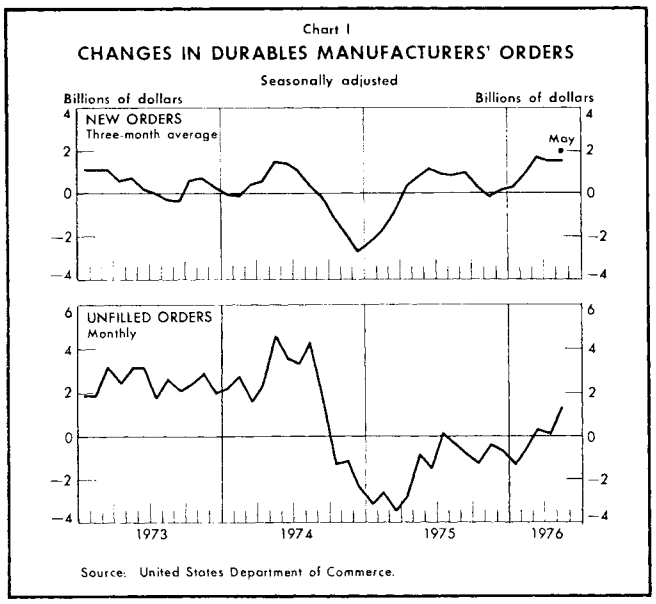
## INDUSTRIAL PRODUCTION, NEW ORDERS, AND INVENTORIES

Industrial production increased in May for the fourteenth consecutive month. The preliminary data indicate that overall output of the nation's mines, utilities, and manufacturing plants rose 0.5 percent, with gains widespread among industries. Nevertheless, this did represent a slowdown from the earlier rate of recovery. Since the trough of the recent business downturn, industrial production has risen 15.8 percent, or more than 1 percent per month according to newly revised data, thus indicating that the recovery has been more robust than previously believed. However, the recent recession was severe by postwar standards, and the overall index has not completely regained its previous peak despite the duration and strength of the recovery.

In May, a particularly strong gain was recorded in the iron and steel industry, where output advanced 3.9 percent. This continued the sharp rebound in steel making that characterized the early months of 1976 and brought the cumulative advance since last December to 15.5 percent. To a large extent, the pickup in steel production is related to the rebound in the production of automobiles. Indeed, although demand for consumer-related flat-rolled steel has been strong, demand from other sources—notably the capital goods and construction industries—has remained relatively depressed. The recent evidence suggests that auto production will not cause steel shortages to develop in the near term. The 1.1 percent increase in output of the motor vehicles and parts industry posted during May was less than half the average increase recorded earlier in the year, and the preliminary data for June show a similar percentage increase in assemblies of domestic passenger cars to an 8.8 million unit annual rate. Contrary to initial fears, the rubber industry strike has not greatly affected auto assemblies, and the usual plant shutdown for the model-year changeover will curtail tire needs temporarily.

Production of business equipment has also displayed recent strength. In May, business equipment production recorded a 1.1 percent gain, following healthy increases in the earlier months of 1976. Despite these gains, however, output in this sector remains almost 7 percent below its previous peak. Business equipment, which includes a wide variety of goods ranging from industrial and farm machinery to equipment used in transport and commercial enterprises, tends to lag in the recovery until utilization of existing productive capacity reaches the point that makes investment in new capital goods attractive.

The latest data on orders received by manufacturers of durable goods suggest that further increases in the output of business equipment are in the offing. According to preliminary estimates, seasonally adjusted new orders for machinery rose by nearly $300 million in May, marking the fifth straight month of sizable growth. Overall, durable goods orders have increased sharply in recent months (see Chart I), rising more than 16 percent in the five months since December. This amounts to an average rise of $1.4 billion per month, compared with $800 million per month during the first nine months of the recovery. The increase in total orders was greater than the rise in shipments in May, the first sizable excess of orders over shipments in nearly two years, resulting in a substantial $1.5 billion increase in unfilled orders. The recent advances in new and unfilled orders augur well for continued activity in the future.




Businesses do, however, seem to be cautious in their plans for expansion and their stockpiling of goods. The data on inventories suggest that there has been some flattening of inventory investment after the acceleration in the winter months. April data on the book value of wholesale and retail trade inventories show a rise of $800 million, about $300 million less than the average rate during the first quarter. Data covering only manufacturing firms show an average accumulation of $500 million per month in April and May, the same rate as in the first quarter of this year.

Some further indication of the course of activity in coming months may be provided by the index of leading indicators. The index rose 1.4 percent in May, the largest increase since last July. Six of the eleven available components advanced, while only three declined. The most important positive factor was the large rise in new orders. While the index is not considered an accurate gauge of future rates of change in economic activity, it is regarded as useful in showing the probable direction of change. The results for May support expectations of further increases in production and purchases.

## PERSONAL INCOME, CONSUMER CONFIDENCE, RETAIL SALES, AND RESIDENTIAL CONSTRUCTION

According to preliminary estimates, personal income rose $11 billion in May, equivalent to a 9.8 percent annual growth rate. Total wage and salary disbursements grew at a slightly greater annual rate of 10.3 percent during the month, reflecting a sharp rise in average weekly earnings in the private nonfarm sector. Although part of the May increase was due to the artificially short workweek in April and should be discounted, a substantial part did reflect an improvement in workers' hourly earnings. Over the past year, advances in weekly earnings and in employment have increased total wages and salaries by 10.7 percent. Because inflation has been more moderate, this represents a sizable rise in the purchasing power of workers. Recipients of other types of income have also gained in recent months. For example, proprietors' incomes grew strongly in April and May, reflecting farm owners' higher profits.

Despite the continued advance in personal income, the spring surveys have indicated a weakening of consumer confidence. The Conference Board survey of March-April showed a sharp drop in consumer optimism, compared with the poll two months earlier. After a year of fairly steady improvement, the index dropped 11 points to 82.2 percent of the 1969-70 average level, and an even more significant retrenchment of near-term buying plans was reported at the same time. A later survey by the University

of Michigan, however, suggested a much less pronounced decline in consumer optimism. Any decline at a time when income and employment growth has been strong is surprising. One explanation offered by a few analysts was uncertainty about inflation, perhaps stirred up by recent food price increases. If price increases remain moderate and personal incomes continue to advance, it seems likely that the recent consumer pessimism will recede.

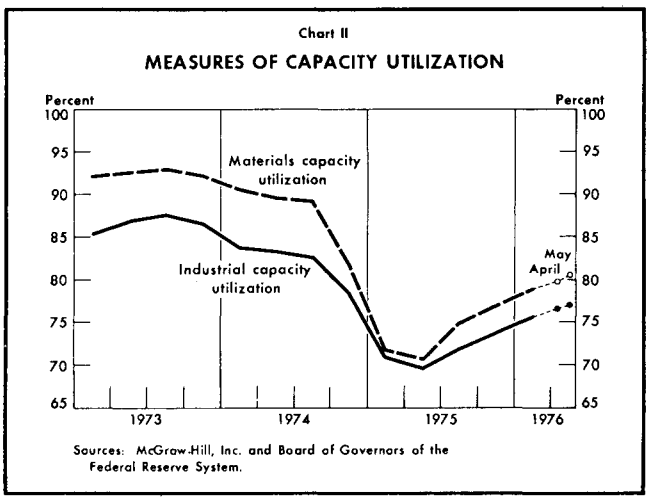
The spring slowdown in retail sales may have reflected the consumers' somewhat less optimistic mood. Seasonally adjusted sales were little changed in April from the March level and fell $1.1 billion in May. However, advance estimates for June showed an increase of $1.4 billion. Domestic-model auto sales also recovered in June, reaching a 9.1 million unit annual rate after a moderate decline in May. Market observers attributed part of the sales increase to price discounts offered on subcompact cars, reflecting auto manufacturers' attempts to reduce swollen inventories before the end of the 1976-model year.

Residential construction activity has been relatively flat this year, although the May data offer some signs of near-term improvement. Permits issued to build new units jumped in May, reaching the highest level in two years, and there was also a slight rise in housing starts. Most of the gain was concentrated in the depressed multifamily sector, where construction had declined in January and February. In May, housing starts of multifamily units increased 12.6 percent and permits issued for new units increased 19.5 percent. While it remains to be seen if the latest pickup in multifamily construction activity presages continued gains, the lower rental vacancy rate and the continued increases in the volume of mortgage commitments at savings and loan associations are conducive to further improvement. Recent news on single-family housing starts has been less favorable than some experts had expected. About half of the decline that occurred between the peak in the third quarter of 1972 and the trough in early 1975 was made up by last December, but there has since been little change.

### RESOURCE UTILIZATION AND PRICES

Although the recovery is now into its second year, the bulk of the economy continues to operate well below productive capacity. Most of the measures of capacity use, as well as those of labor market tightness, suggest that output expansion could proceed further in the near term without causing an acceleration in price and wage inflation.

McGraw-Hill reported that output stood at 77 percent of capacity in May (see Chart II). Although up more than 7 percentage points from the trough level, utilization as recorded by this survey is well below the 88 percent level attained in the third quarter of 1973. More interesting to those worried about production bottlenecks is the situation in the industries that produce materials. The Federal Reserve Board has compiled a new index of capacity utilization in the materials industries that provides further insight on this sector. The new index represents a larger share of industrial production than the old major materials series and thus offers a more comprehensive view of cyclical movements in materials utilization.




According to the new index, utilization in May stood at 80.4 percent of capacity, up 10 percentage points from its low point in the second quarter of 1975. The current rate of capacity use appears to be fairly comfortable by historical standards. In the third quarter of 1973, when capacity constraints generated shortages and production delays, this index stood at 93 percent, 13 percentage points above its May 1976 level. Although recent increases in capacity utilization by materials producers have been widespread, they have been somewhat larger in nondurable materials industries, where the resurgence in demand began earlier. Indeed, production facilities are reported by some as being pressed in a few industries, such as paper and textiles, though the pressure appears to be limited to a few product lines and, at least in the near term, should not create severe bottlenecks. Moreover, to the extent that capacity additions are planned in these areas and there are not long delays in the production of capital goods, the possibility of substantial shortages is reduced.

While the capacity utilization data appear encouraging for the price picture, one should not rely too heavily upon

them. Productive capacity is as much an economic as an engineering concept, and the cost of using any particular unit depends on how obsolete it is. If part of existing capacity either is old or reflects outmoded techniques, there may be substantially higher production costs associated with its use, and cost pressures could emerge before utilization reaches historically high levels.

The information on labor market conditions indicates that, despite substantial gains in employment since the onset of the recovery, there are still large numbers of persons available for work. Total civilian employment has risen by 3.1 million in the year since the second quarter of 1975, and 1.1 million of this increase occurred in the second quarter of 1976. Continued growth of the civilian labor force, however, has meant that employment gains have not resulted in equivalent reductions in unemployment. The unemployment rate, one measure of unutilized labor, averaged 7.4 percent in the second quarter, down 0.2 percentage point from its value in the first quarter. Although it is substantially below its peak of 8.7 percent in the second quarter of 1975, the rate is still relatively high. For example, in the 1970-74 period, which included the major part of two recessions, the unemployment rate averaged less than 6 percent.

At current and recent rates of capacity and labor force utilization, many economists would expect a gradual abatement of inflationary pressures. Although the volatile monthly changes do not show this very clearly, comparison of the average rate of price increase thus far in 1976 with that in the last half of 1975 does reveal some easing. For example, consumer prices rose at an average annual rate of 4.2 percent between December and May, while the rate of increase averaged 7.2 percent in the last six months of 1975. A significant deceleration in average hourly earnings (adjusted to exclude interindustry employment shifts and overtime in manufacturing) was also noticeable, as earnings increased at a 6.3 percent annual rate in the first six months of 1976 as compared with a 7.4 percent rate in the last half of 1975.

Although the average rate of inflation has slowed somewhat, the recent price news has been less favorable than it was earlier in 1976. However, many of the factors that caused the sharp moderation in the winter months, such as gasoline and food price declines, were expected to reverse course and result in an acceleration later in the year. Food prices at the consumer level moved upward in April and posted a further hefty increase in May, causing the overall index to rise at a 7.1 percent annual rate. Excluding food and energy, however, the rate of increase during May was 5.2 percent, consistent with the widespread view on the underlying trend in the inflation rate. Some encouragement could also be found in the behavior of prices of services, such as rent, transportation, medical care, and consumer interest rates. The services component rose at a 5.4 percent annual rate in May, duplicating the moderate rate of April. In the six months prior to April, the average rate of increase had been a rapid 9.7 percent.

The seasonally adjusted wholesale price index rose in June by 0.4 percent, which was somewhat faster than the average increase of the preceding five months. Prices of farm products and processed foods and feeds have added upward pressure to the index since early spring, although in June this component rose less sharply than in the preceding two months. Prices of industrial commodities, on the other hand, rose 0.5 percent in June, which was considerably more rapid than the average rate of increase during the preceding five months. From a longer term perspective, however, the behavior of industrial commodities prices has been relatively favorable. During the first six months of the year, prices of industrial commodities increased at a moderate 3.4 percent annual rate, down substantially from the 9.2 percent rate in the last half of 1975.

# The Business Situation

As had been widely expected, the figures on gross national product showed a marked slowing in the growth of real output during the second quarter after the first quarter's very rapid rate of advance. The reduced overall rate of gain was related largely to a leveling-off of inventory spending and to the slower rise in consumer spending that had already been suggested by weaker retail sales in April and May. Most recently, the economic advance has continued, but at a rate closer to the moderate second-quarter pace than to the more exuberant first quarter. Both personal income and industrial production showed the smallest rises of the year in June, and the rise in the leading indicators was also of quite modest proportions. Consumer spending apparently has shown some signs of improvement after the April-May weakness, but housing is still having trouble launching the second stage of its post-recession revival. The extent to which stronger capital spending will contribute to expansion over the months ahead remains uncertain, but new orders for capital goods did post another good rise in June. Employment resumed its growth in July, but a very large jump in the civilian labor force pushed the unemployment rate up for the second successive month.

Continuing and somewhat worrisome advances in the prices of industrial raw materials aside, the price-wage picture has remained relatively favorable. To be sure, prices generally rose at a somewhat more rapid rate in the second quarter than in the first three months of the year. However, this acceleration reflected a widely expected turnaround from the outright declines in food and energy prices that had occurred in the first quarter. Wage increases remained large but continued to show some signs of moderating, and relatively large productivity gains associated with the economic recovery have helped significantly to reduce labor cost pressures.

## GNP AND RELATED DEVELOPMENTS

According to preliminary Department of Commerce estimates, the market value of the nation's output of goods and services (GNP) rose at a 9.3 percent rate in the second quarter. After adjustment for changes in prices, the rate of gain in GNP was a moderate 4.4 percent. While this increase in real terms was significantly slower than the rapid 9.2 percent expansion of the previous quarter, it was the fifth consecutive quarterly advance and pushed the level of output well above its pre-recession peak. Much of the gain during the first quarter was attributable to a sharp increase in inventory investment that resulted from a swing from inventory liquidation at the close of 1975 to accumulation in the first quarter. Since inventory accumulation stabilized in the second quarter, inventory investment actually restrained growth in real GNP over this period (see Chart I). In keeping with these developments, the Federal Reserve Board's index of industrial production rose more slowly in the second quarter than in the first. Indeed, the June gain was the smallest in nine months, but the uneven pace of the current recovery is not at all unusual for a sustained business expansion. For the most part, the lack of uniformity reflects the often erratic changes in inventory investment. From a longer term perspective, the current expansion at its present stage is close to or slightly ahead of earlier recoveries (see Chart II).

While inventory investment slowed the second-quarter growth of GNP, final sales—GNP less the inventory component—rose slightly more than in the first quarter. Spending by consumers continued to expand over the April-June period, but the rate of increase slowed from the exceptionally rapid pace of the preceding three months. Personal consumption expenditures in real terms rose at a 4.1 percent annual rate in the second quarter, down from the 8.9 percent growth posted in the first quarter. The slowdown in consumer purchases of durable goods was particularly pronounced. Sales of new domestic passenger cars averaged a healthy 8.9 million units at an annual rate during the April-June period, but the sales increase was not so large as the gain registered in the first quarter. At least part of this slowing may be attributed to short supplies of some popular models. Purchases of new cars have recently accounted for about 23 percent of consumer durable goods outlays. Spending on other durables rose only slightly in real terms during the second quarter.

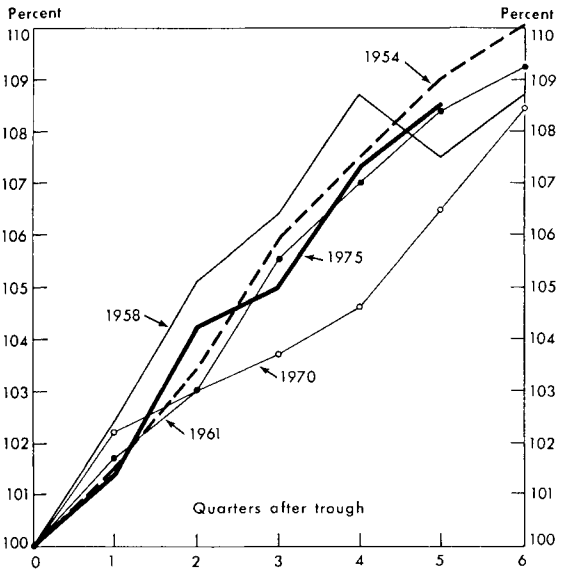
To some extent, the slowdown may simply reflect another pause in the growth of consumer spending, such as occurred after the sharp increase in the second quarter of 1975. Also, consumer spending typically rises less rapidly after the first year of an expansion. Emerging from recession, consumers are encouraged by income gains and other favorable developments to begin making purchases that were deferred during the recession. The willingness to reduce the proportion of disposable income devoted to saving supports the growth of expenditures for a time, but this support diminishes as the saving ratio—the ratio of saving to disposable personal income—returns to normal levels. In the second quarter, the saving ratio was 7 percent, essentially unchanged from the previous quarter but considerably below the rather high average of 7.8 percent for all of 1975. In the longer run, saving has averaged about 6 percent of disposable income, suggesting that there could well be room for a further near-term decline in the ratio which would provide stimulus to consumption spending. Changes in this ratio are irregular, however, and reflect variations in consumer confidence as well as other factors. In March and April, consumers expressed somewhat less optimism about the near-term economic outlook and contemplated a retrenchment of buying plans. Later evidence suggests that consumer confidence improved toward the end of the second quarter. Further improvement in consumers' attitudes could encourage resumption of the decline in the saving ratio toward its longer run average and thereby foster continued gains in consumption expenditures.

Residential construction expenditures advanced further in the second quarter, although the strong growth experienced during the last half of 1975 was not maintained over the first half of this year. Private housing starts rose slightly during the April-June period to a 1.43 million

Chart II

REAL GROSS NATIONAL PRODUCT IN RECOVERY

INDEXED AS A PERCENTAGE OF TROUGH-QUARTER LEVEL*




Note: The National Bureau of Economic Research has dated recession troughs in the second quarter 1954, second quarter 1958, first quarter 1961, fourth quarter 1970. The first quarter of 1975 was used as the date for the most recent trough.

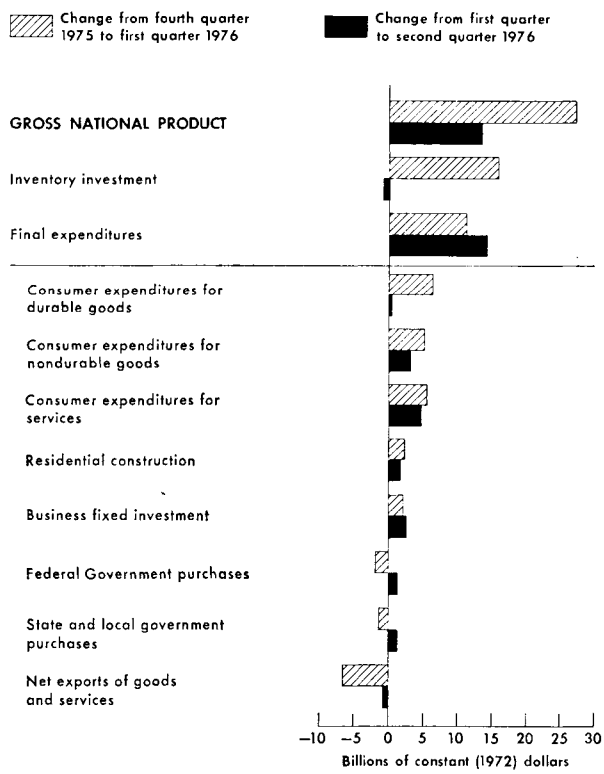
*Each reference-cycle expansion is dated from the year in which the trough quarter occurred, and the trough level equals 100 percent.

Source: United States Department of Commerce, Bureau of Economic Analysis.

Chart I

RECENT CHANGES IN REAL GROSS NATIONAL PRODUCT AND ITS COMPONENTS

Seasonally adjusted




Source: United States Department of Commerce, Bureau of Economic Analysis.

unit annual rate, as a substantial increase in starts of multifamily dwellings more than offset a decline in the number of single-family homes started. Permits issued to build new units fell a bit, entirely in the one-family area. In light of relatively heavy backlogs of new single-family homes for sale, the outlook for single-family building is uncertain. Unless sales begin to pick up, the current stock of unsold homes will tend to hold down the number of single-family starts. On the other hand, the continued growth both of real disposable income and of mortgage commitments at thrift institutions may provide support for construction activity in coming months.

Capital spending picked up further in the second quarter. While gross investment in real terms is still about 14 percent below its previous peak, the April-June advance —9.6 percent at an annual rate—marked the third consecutive quarterly increase after six quarters of decline. Outlays for structures accounted for nearly one half of the second-quarter increase. This sharp rise still left spending on structures substantially below pre-recession levels, but it might signal the beginning of work on "greenfield" plants, which represent entirely new facilities, by industries anticipating reaching capacity in the near term. Other firms with more leeway to expand production in available plants continued to modify existing buildings and equipment and to purchase new capital goods in response to expanding demand. Surveys of investment plans indicate only modest additional gains in outlays in the months ahead. These plans are subject to revision, however, and the incoming data on new capital equipment orders suggest somewhat greater strength.

According to preliminary and incomplete data, net exports of goods and services declined in real terms for the second straight period, but the reduction during the three months ended in June was much smaller than the substantial first-quarter drop. Changes in imports again played the dominant role. Imports grew less rapidly during the second quarter than in the previous three-month period, when the rapid growth of domestic activity stimulated demand for foreign products partly to accumulate inventories. The level of exports changed little in real terms during the second quarter, though there was some rise in exports of goods. Export demand should continue to increase as the economies of major American trading partners move further into the recovery phase of the business cycle. A smaller cyclical difference in growth rates would tend to improve the net export balance, and an early sign of this may have been the narrowing of the current-dollar merchandise trade deficit in the second quarter despite further increases in fuel imports.

Total government purchases rose $2.7 billion in real terms during the second quarter, nearly recouping the decline that had occurred during the January-March period. The increase was evenly split between the Federal and the state and local sectors. National defense purchases accounted for much of the increase in Federal outlays for goods and services. Preliminary data suggest, however, that Federal purchases in fiscal 1976, which ran from July 1975 through June 1976, were lower than the Government had expected, and some of this spending may be shifted to later in the calendar year as a consequence of changes in budget procedures now taking effect.

Spending authority for most current operations, many of which contribute to Federal purchases of goods and services, usually lapses at the end of a fiscal year. Funds appropriated but not spent by the start of the next fiscal year generally cannot be carried over, and new Congressional action is required for further operations. This arrangement has often resulted in a seasonal bulge during June in spending, which tended to be smoothed out in derivation of seasonally adjusted levels. The Congressional Budget and Impoundment Control Act of 1974, however, established new budget procedures for the Congress and shifted the start of the new fiscal year to October to give lawmakers a better chance of completing action on appropriations before the Government actually begins spending money. Implementation of these procedures has created a transition quarter from July through September 1976, during which fiscal 1976 spending authority remains in effect. The various Federal departments were therefore under less pressure than usual to complete scheduled spending by the end of June, and at least some of the outlay shortfalls in defense and other areas are likely to be made up during the third quarter.

## PRICES

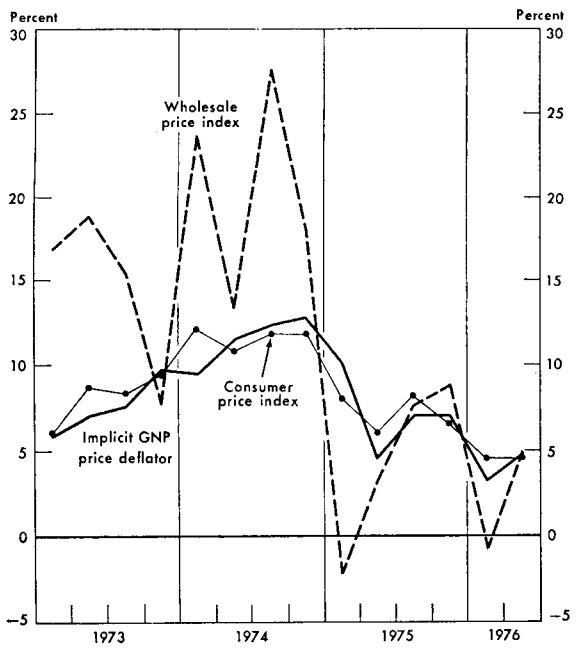
The latest readings on inflation continue to be moderately encouraging. The major indicators suggest that the general price level rose at a somewhat faster rate in the second quarter than in the first, but this acceleration reflects the absence of the outright declines in prices of certain items that occurred in the January-March interval rather than mounting inflationary pressures. The implicit price deflator for GNP, the broadest of the official price indexes, rose at a 4.7 percent annual rate in the second quarter (see Chart III). This was 1.5 percentage points above the first-quarter figure, which was depressed by falling prices for some food and energy products, but was about half the average inflation rate experienced during the 1974-75 period. The fixed-weight deflator, which holds the composition of output constant, showed a

smaller increase from 4.2 percent in the first quarter to 4.7 percent in the second. The mild acceleration can be attributed to the food and energy components, since prices of other goods and services rose at a 6.2 percent rate in the first quarter and a 4.6 percent rate in the April-June period.

As for wholesale prices, the switch from a slight decline in the first quarter to a 4.9 percent annual-rate increase in the second stemmed from movements in the volatile food component. Farm products and processed foods and feeds prices rose on a quarterly average basis at an 11.3 percent annual rate in the April-June period, compared with a 17.3 percent rate of decline during the first three months of the year. By contrast, wholesale prices of industrial commodities climbed at only a 3.1 percent rate in the second quarter, compared with a 5 percent first-quarter increase.

Prices of consumer goods and services followed a similar pattern. Excluding food and energy, the rate of increase in consumer prices decreased from an 8.1 percent rate in the first quarter to a 6.2 percent rate in the second.

Chart III
RECENT PRICE BEHAVIOR
CHANGE FROM PREVIOUS QUARTER AT ANNUAL RATE
Seasonally adjusted




Sources: United States Department of Commerce, Bureau of Economic Analysis and United States Department of Labor, Bureau of Labor Statistics.

Food prices increased at a modest 1.6 percent rate, after declining during the first three months of the year. With near-record grain crops in prospect and marketings of livestock also likely to increase, the outlook for retail food prices seems favorable, depending of course on the weather and on foreign demand.

## WAGES AND PRODUCTIVITY

Wage pressures moderated slightly further in the second quarter of 1976. Average hourly earnings of private nonfarm production and other nonsupervisory workers, adjusted to exclude the impact of interindustry shifts in employment and of overtime in manufacturing, rose at a 6.1 percent annual rate during the second quarter, a bit less than in the preceding three-month period. Similarly, major collective bargaining settlements reached in the second quarter provided for a somewhat slower increase in wages and benefits than did those in the January-March interval. During the first half of 1976, the average first-year wage and benefit gain negotiated in contracts covering 5,000 or more workers was 8.9 percent, down from 10.9 percent in the corresponding period of 1975. First-year wage increases alone, under contracts covering 1,000 or more workers, also decelerated in the second quarter, though the number of workers affected by contract expirations increased. During the first three months of the year, contracts expired for 913,000 workers. In the second quarter, the figure rose to more than 1.5 million, about 10 percent of whom had not negotiated new contracts by the end of June. The collective bargaining schedule will be nearly as heavy in the July-September period, with the automobile and farm equipment industries most affected.

Productivity, as measured by output per hour worked in the private business sector, rose at a 3.6 percent annual rate in the April-June period, compared with the rapid 7.5 percent rate in the previous quarter and 1.4 percent in 1975. In contrast, the growth of productivity in the manufacturing sector alone increased from a 5.1 percent rate in the first quarter to a 7.8 percent rate in the second. Unit labor costs in the private business sector rose at a 3.6 percent annual rate in the April-June period, while a smaller increase in the manufacturing sector left unit costs there still below the year-earlier level. Annual productivity gains of about 3 percent were achieved in the private economy during the 1947-67 period. The increase in more recent years has averaged only about 1.5 percent, causing some concern about future gains, but the presence of underutilized capacity permits more rapid increases in the early stages of a recovery.

As for labor market conditions, the number of persons employed rose by 407,000 in July, in line with the average monthly increase during the first half of the year. The civilian labor force, however, grew by 690,000 during the month. As a result, the unemployment rate rose from 7.5 percent in June to 7.8 percent in July, with adult women accounting for most of the increase. As conventionally measured, growth of the civilian labor force tends to slow when unemployment is high because job seekers become discouraged. Those who do not seek jobs are not counted as being in the labor force. Conversely, an improvement in the unemployment picture brings previously discouraged workers back into the labor force. This movement slows the reduction in the unemployment rate, unless the growth of employment is particularly strong. The 2.2 million increase in the civilian labor force since December exceeds the annual rise in either of the two preceding years.

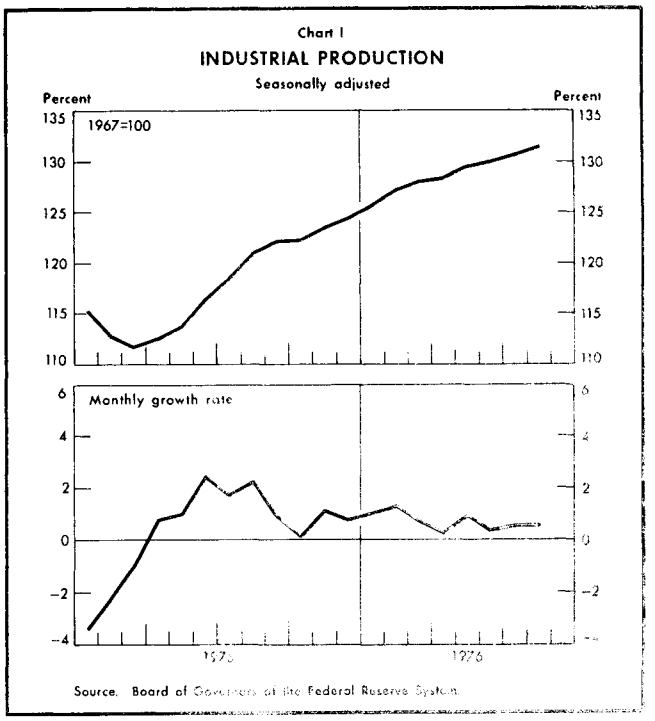
# The Business Situation

Recent business statistics suggest that the economy is continuing to move up, although it is still too early to tell whether the pattern of slower growth evident since last spring has ended. Consumer spending showed renewed strength in August, as retail sales posted a sharp and broadly based advance. At the same time, housing starts and newly issued building permits increased substantially, providing signs of prospective strengthening in residential construction. Distinctly less encouraging, however, were the August declines in durable goods orders and in the index of leading indicators. Overall, while business activity continues to exhibit upward momentum, the extent of the strengthening, if any, is difficult to assess. Capital spending is likely to play a key role in the months ahead, but the outlook for such expenditures is unclear. On a more positive note, while the nationwide automobile strike has entered into the fourth week, a tentative contract agreement has been reached.

The latest price data have been mixed. At the consumer level, overall price increases have been running at around a 6 percent annual rate for the past several months, but wholesale price increases accelerated in September. Some other developments have been more favorable for the price outlook. Most notable are recent price developments in major metals industries. Steel producers rescinded some previously announced price hikes, and aluminum firms postponed price increases. In addition, spot prices of raw industrial commodities, which are generally regarded as particularly responsive to demand pressures, registered outright declines in September for the second successive month.

## INDUSTRIAL PRODUCTION AND CAPACITY

Industrial production rose in August for the seventeenth consecutive month, according to the Federal Reserve Board's index. Preliminary estimates show that output of the nation's mines, utilities, and manufacturing establishments rose 0.5 percent in that month, the same as the increase recorded in July (see Chart I). Following the sharp cyclical expansion in the early months of the recovery, the rate of growth in production has slowed noticeably in recent months. Nevertheless, output in August was about 18 percent above its trough level reached in March 1975. In large measure, some moderation in production gains was to be expected as the recovery matured. In fact, at this point in the recovery, the growth of production is comparable to that in most previous postwar recoveries. Nonetheless, the recent data have been distorted by strikes in the rubber and coal industries, and production in September was affected by the strike of the United Auto Workers' union against the Ford Motor Company, which began on September 15. Recent gains in industrial output have been concentrated largely in durable



goods materials, business equipment, and construction supplies. Production of consumer goods has been relatively unchanged in recent months, no doubt reflecting a response to the midsummer lull in consumer buying.

While the continued growth of industrial production has raised the level of output close to its pre-recession mark, concerns over the reemergence of widespread capacity problems appear to have diminished. Virtually all measures of capacity utilization indicate that the economy is operating well below its productive limits. The McGraw-Hill measure of manufacturing utilization stood at 77 percent in August, well below the 88 percent peak recorded in 1973. The Federal Reserve Board's index of capacity utilization in materials-producing industries, which is generally regarded as a sensitive indicator of possible production bottlenecks, also is far below its peak. The level of plant and equipment utilized in the materials-producing sector stood at 81.5 percent in August, some 11.5 percentage points below the peak rate attained in August 1973. Thus, the latest readings suggest that there is ample capacity available to accommodate continued growth of the economy. Moreover, the likelihood of constraints being reached in the near term has been further reduced, of course, by the more moderate rate of growth of real output experienced in the spring and summer.

## MANUFACTURERS' ORDERS AND INVENTORIES

Durable goods manufacturers' new orders fell 1.5 percent in August. The decline resulted mainly from a substantial drop in new orders for nondefense capital goods, which, in contrast, had posted an unusually large increase in the previous month. Because month-to-month changes in any economic series can be erratic, such large offsetting movements are not particularly meaningful. Because of concern over the behavior of capital spending thus far in the recovery, however, the decline in capital goods orders has raised, to some extent, renewed anxiety over the outlook for this sector. While there can be little doubt that this sharp decline diminishes somewhat the otherwise generally brightening picture for business fixed investment, its importance should not be exaggerated. Aside from the August drop, nondefense capital goods orders have increased continually this year. Bookings for defense goods recovered in August, after dropping sharply in July. The recent erratic movements in defense orders might be related to the changeover by the Federal Government to a new fiscal year.

Inventories in manufacturing and trade continued to rise, by $1.6 billion in July, with nondurables manufacturing and durables retail trade accounting for most of the increase. The accumulation began in January in response to a strong pickup in sales and continued into the summer, partly as a result of the recent sluggish growth in final sales. Hence, the inventory-sales ratio has rebounded recently, although it has remained well below the level of a year ago. As in July, manufacturers' inventories rose by more than $900 million in August, owing mainly to the buildup in the nondurables sector.

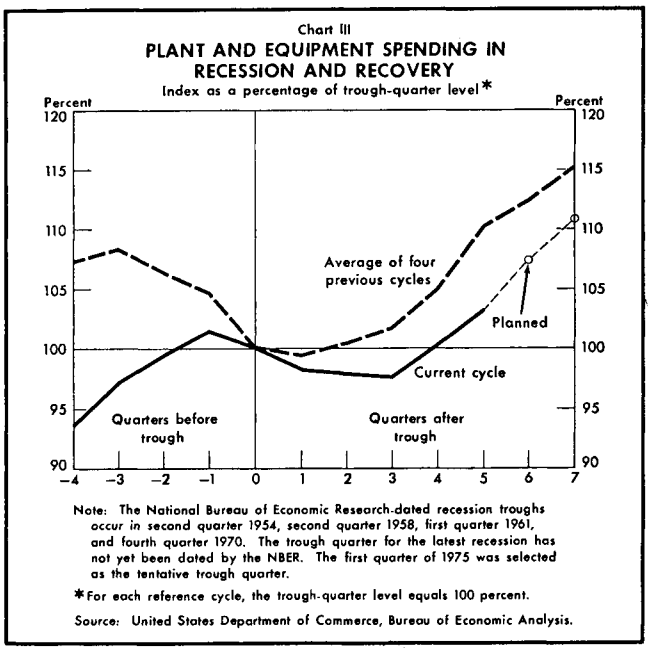
The index of leading indicators fell 1.5 percent in August, with the decline related to the recent sluggishness in consumer spending and some areas of capital investment. Contributing heavily to the drop were the rise in the manufacturing layoff rate, the decrease in contracts and orders for new plant and equipment, and the shortening of the average workweek in manufacturing. While the August decline—the first in eighteen months—may contribute to anxiety over the future course of the economy, a one-month decrease is not sufficient to signal a stalling of the recovery. Historically, the index has turned down, sometimes for several months, even though the economy subsequently continued to expand.

## RETAIL SALES AND PERSONAL INCOME

Following several months of lackluster performance, retail sales rebounded strongly in August, rising 2.3 percent on a seasonally adjusted basis. After adjustment for higher prices, this represented an increase of 1.9 percent, pushing sales in constant-dollar terms slightly above the previous peak registered in April. The August sales gain was broadly based, with all major categories of retailers—particularly auto dealers and department stores—posting substantial gains. Some analysts have contended that auto sales would have been even stronger except for shortages of some popular models. It may also be, however, that in efforts to reduce stocks of existing models dealers have offered generous price concessions and consumers have responded by snapping up the available models.

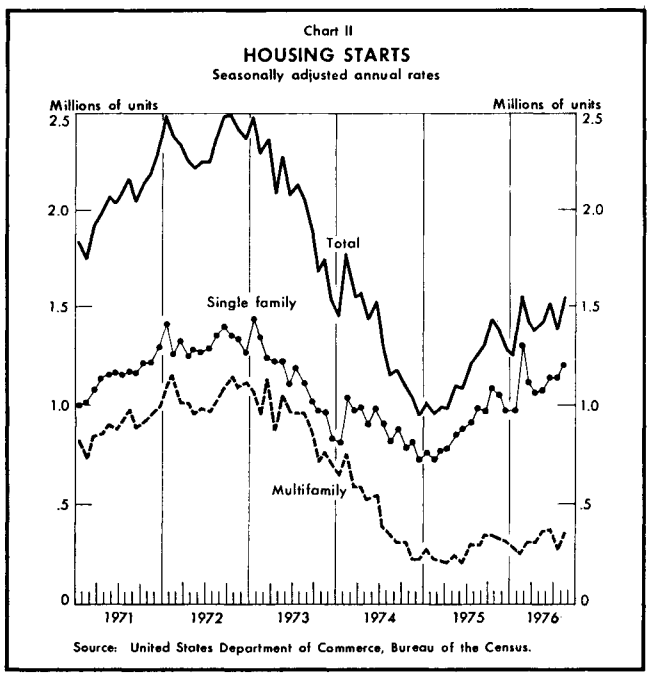
Since last April, retail sales have fluctuated irregularly, with an increase in one month followed by a decrease in the next. The failure of retail sales to break out of this pattern is generally considered a major factor in the overall slowing in the nation's economic advance. A prolonged pickup in sales depends on consumers' willingness to spend as well as on the growth of income and employment. In this regard, the latest surveys of consumers' attitudes suggest no change in their assessment of the economy or in their interest in buying big-ticket items. On the other hand, the prospects for continued gains in personal income appear good. After a strong surge in July due

mainly to the midyear cost-of-living increase in social security benefits, personal income posted a more modest increase in August. Part of the slowdown was attributable to the small advance in that month of average hourly earnings in the private nonfarm economy. A decline in farm income, as a result of a sharp drop in wholesale prices of farm products during the month, also was important in moderating the personal income gain. From a longer term perspective, personal income has grown at better than a 9 percent annual rate over the first eight months of the year, well above the experience of earlier recovery periods.




## RESIDENTIAL CONSTRUCTION AND CAPITAL SPENDING

Housing activity showed some encouraging signs in August, with housing starts rising to a seasonally adjusted annual rate of 1.54 million units (see Chart II). This was the highest level of activity since April 1974 and put the level of building activity some 22 percent above a year earlier. Much of the August increase was in the multifamily sector, where starts rose from about 260,000 to nearly 350,000 units. Since one of the major factors restraining the recovery in residential construction activity has been weakness in the multifamily sector, the pickup in starts in this sector was particularly encouraging. Further bolstering near-term prospects was a jump in permits to build apartment complexes of five or more units. Despite this tentative evidence of a pickup in the multifamily sector, the level of activity remains well below that of the peak years of 1972 and 1973. The single-family sector, which has staged a stronger recovery, exhibited renewed strength in August. Single-family starts rose to 1.2 million units, and newly issued permits increased to their highest level since early 1974.




According to the Commerce Department survey taken in July and August, business spending on plant and equipment is expected to rise 7.4 percent in 1976, little changed from the 7.3 percent increase indicated in the previous Commerce Department survey. However, while the year-over-year growth has changed only slightly, there has been a substantial redistribution of the pattern of spending. As a result, spending in the final quarter of this year is expected to be substantially above that planned earlier. While capital spending typically lags the general recovery, thus far in the current business expansion capital spending has been trailing unusually far behind (see Chart III). Plant and equipment spending currently is only 3 percent above the trough-quarter level. In contrast, at comparable

points in previous postwar recoveries, capital spending had typically registered better than a 10 percent gain. Since this comparison is in nominal terms, allowing for the faster rate of inflation in the current recovery would further underscore the recent sluggishness of capital spending. Provided that the revised expenditure plans are realized, the gap between the current experience and earlier recoveries will be reduced. Even more importantly, the prospective revival in capital outlays could go a long way toward quickening the overall pace of activity.

## RECENT PRICE DEVELOPMENTS

There has been little indication of a fundamental change in the price situation. Consumer prices rose at a 6.3 percent annual rate in August, only slightly higher than the increase posted over the preceding three months. Retail food prices rose at a 4 percent rate, a somewhat more rapid increase than the very modest advances of the two prior months. With a large harvest in prospect, the outlook for food prices in coming months continues to be favorable, although the weather always adds an important element of uncertainty. Consumer power and fuel prices continued to increase at a rapid rate in August; on the other hand, price increases for consumer services moderated somewhat to a 6.6 percent annual rate.

Fragmentary information about prices of goods at the initial stage of the production process suggests that some further diminution in inflation may be forthcoming. There have been reports of price concessions and increased discounting on a number of basic raw materials. Additional evidence on this was provided by the September survey of the National Association of Purchasing Management, which reported a continued decline in the proportion of respondents facing higher prices. Moreover, steel manufacturers rescinded a previously announced price hike, while aluminum producers postponed planned price increases. In addition, spot commodity prices dropped considerably in August and September, according to the Bureau of Labor Statistics index.