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

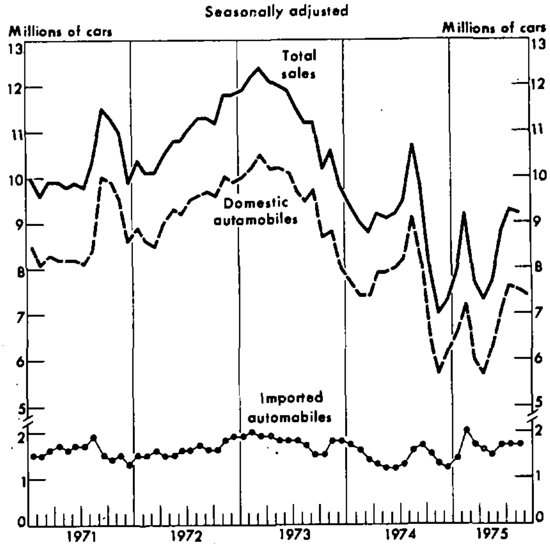
Propelled by a record expansion of factory payrolls, personal income jumped by 1.5 percent in August. Wage and salary disbursements shot ahead at an $11.6 billion annual rate, compared with an average increase of $2.2 billion in the first seven months of 1975. Almost half of the August increase was in 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,

Chart I

AUTOMOBILE SALES

Seasonally adjusted



Sources: Domestic automobile sales: Board of Governors of the Federal Reserve System; imported automobile sales: United States Department of Commerce, Bureau of Economic Analysis.

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.

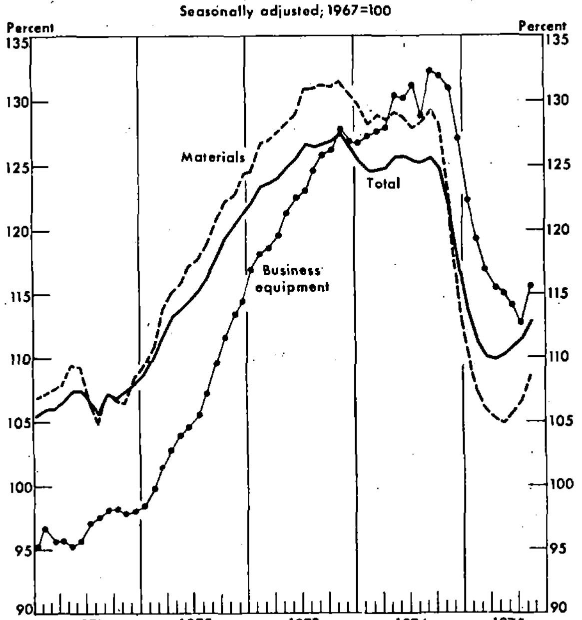
In inflationary periods, book value data tend to give a distorted picture of the inflationary situation. However, the most recent monthly movements in book value inventories are consistent with the pattern of the ratios of real inventories to real sales in the first half of 1975. Real inventory figures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

Chart II

INDUSTRIAL PRODUCTION

Seasonally adjusted; 1967=100



Source: Board of Governors of the Federal Reserve System.

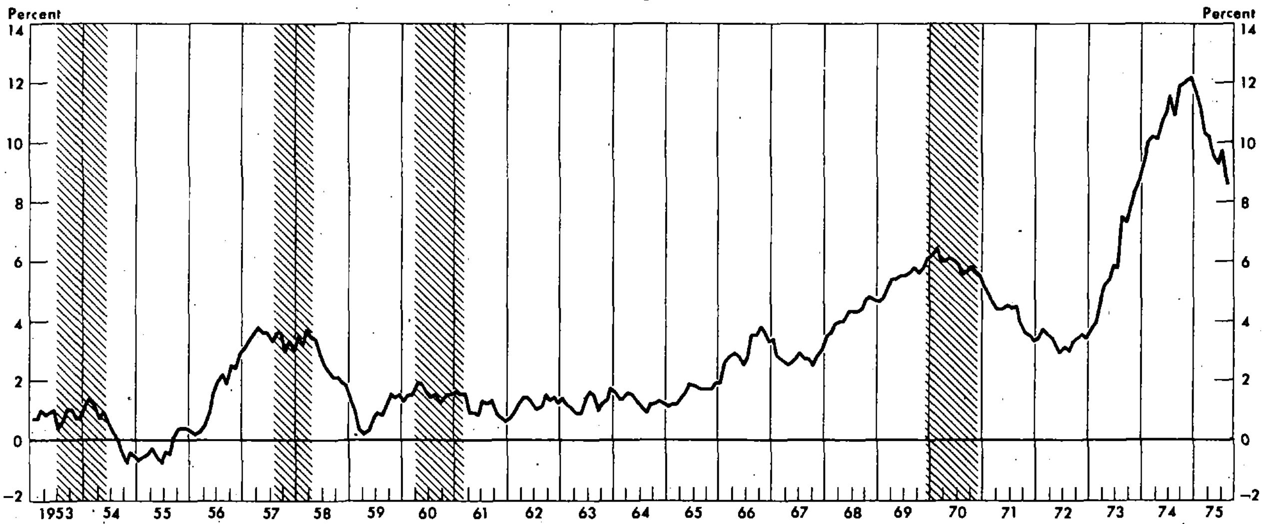
LABOR MARKET DEVELOPMENTS

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

Chart III

CONSUMER PRICES

Twelve-month growth rate



Note: Shaded areas represents 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 Labor, Bureau of Labor Statistics.

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.