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 currentdollar 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).

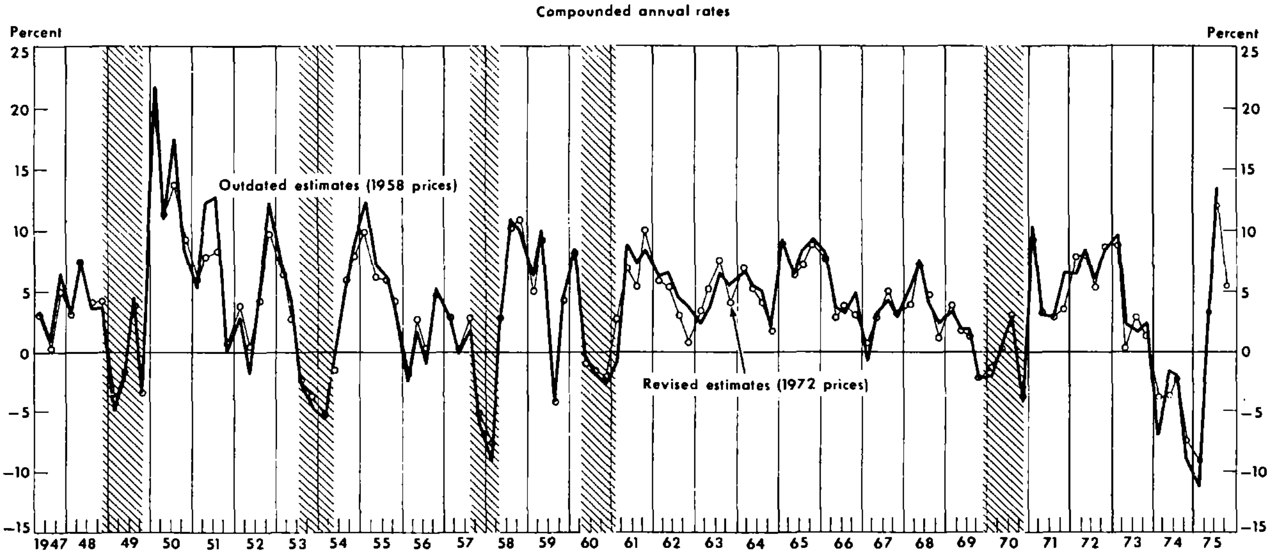
The fourth-quarter gain in real GNP was widely distributed among the spending components (see Chart II). Inventory spending turned positive but added little to the momentum of the recovery. Indeed, the turnabout in inventory spending accounted for only about 6 percent of the total gain in real GNP, unlike 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.

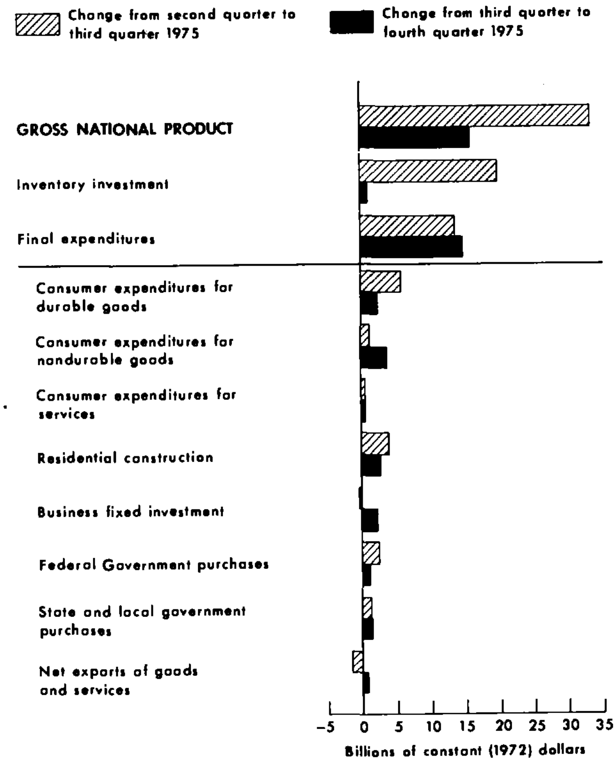
Source: United States Department of Commerce, Bureau of Economic Analaysis.

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.

Chart II

RECENT CHANGES IN REAL GROSS NATIONAL PRODUCT AND ITS COMPONENTS

Seasonally adjusted



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

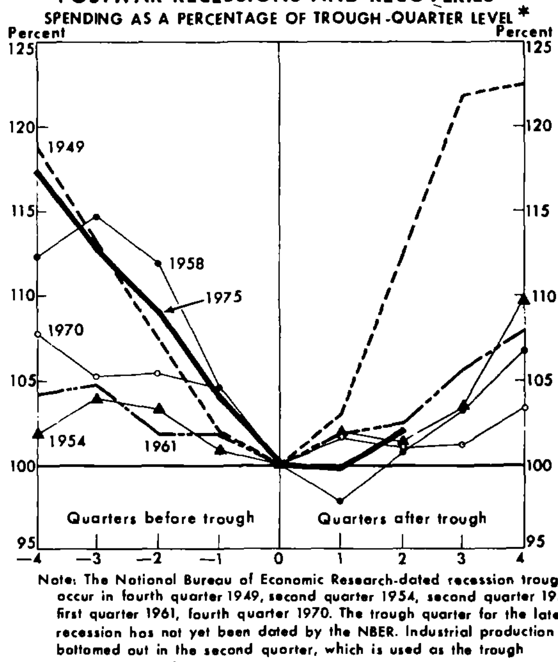
As inventory spending takes on a more passive role in the current cyclical upturn, consumption spending will come to play an increasingly vital role in setting the pace of the recovery. In the fourth quarter, consumption spending increased at a less than vigorous 3.5 percent annual rate in real terms. 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.