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.

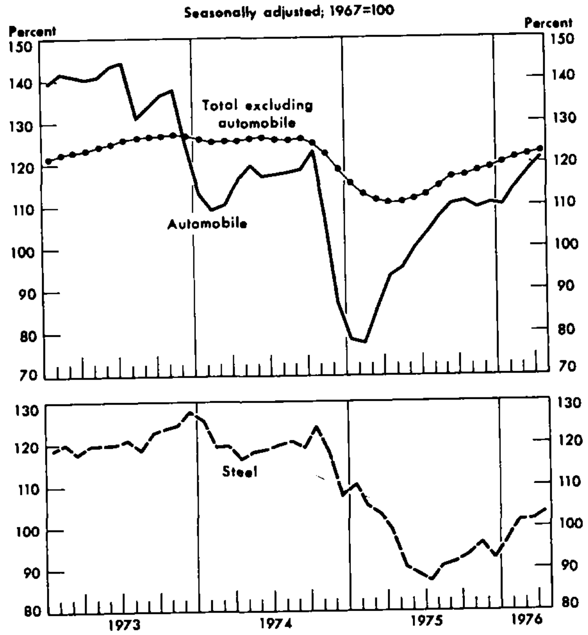
INDUSTRIAL PRODUCTION, ORDERS, AND INVENTORIES

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.

Chart I
INDUSTRIAL PRODUCTION COMPONENTS
Seasonally adjusted; 1967=100



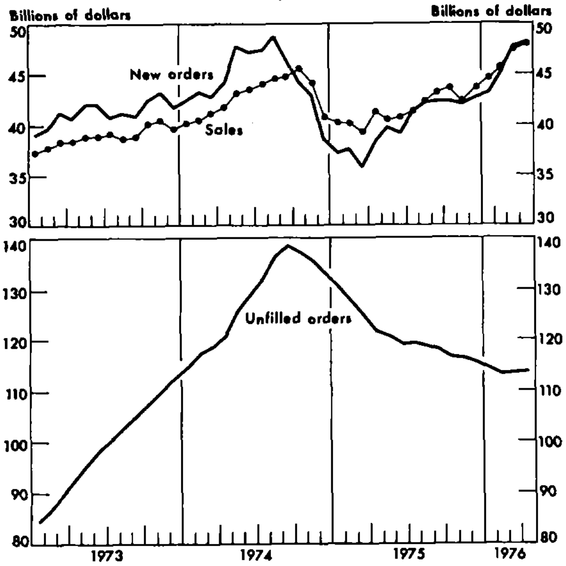
Source: Board of Governors of the Federal Reserve System.

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

Chart II
DURABLES MANUFACTURERS' SALES AND ORDERS
Seasonally adjusted



Source: United States Department of Commerce.

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.

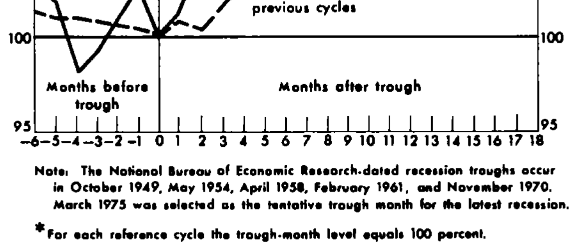
The improvement in incomes has been reflected in sizable increases in consumer purchases in the past year. Between April 1975 and April 1976, retail sales grew by 13.8 percent. Even allowing for price rises, this is a substantial increase. Typically, in the twelve months after a business-cycle trough, 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

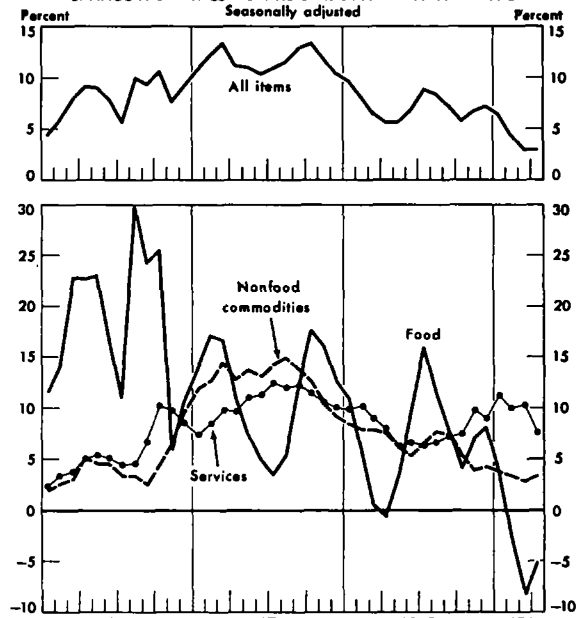
Although there has been a substantial moderation in the trend rate of inflation during the past eighteen months, movements about this trend at both the wholesale and the retail levels have reflected large swings in farm prices. For example, in the final months of 1975 and the early months of 1976, farm 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.

Chart IV
CONSUMER PRICE COMPARISONS FOR ALL ITEMS AND COMPONENTS
CHANGE FROM THREE MONTHS EARLIER AT AN ANNUAL RATE
Seasonally adjusted



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