The Business Situation

The growth of economic activity remained modest during the first months of the summer. In July, industrial production registered only a small gain while both housing starts and retail sales declined. Employment gains were small in August, and the rate of joblessness increased for the third successive month. At the same time, however, evidence suggesting that the pause in activity would be temporary continued to mount. Personal income posted a large advance in July, which should help to stimulate consumer spending, and the Department of Commerce index of leading indicators advanced for the seventeenth consecutive month. Residential building permits rose and prospects for increased outlays for business fixed investment improved, as new orders for nondefense capital goods jumped sharply.

Although month-to-month price changes are volatile and difficult to interpret at times, the overall performance of most key indicators suggests that inflationary pressures are gradually diminishing. Wage settlements remain high but are generally decelerating and, when advances in productivity are considered, cost pressures appear to have moderated. In the consumer sector, favorable movements in food prices have helped hold overall price increases to about a 4½ percent annual rate over the first seven months of this year. On the wholesale front, overall price gains have been moderating. While price increases for industrial commodities accelerated over the three-month period ended in August, steel producers appear to have dropped plans for further price hikes this fall. Prospects of improved foreign production and record-size domestic crops have been reflected in reduced spot food prices, and wholesale food prices have continued downward.

PRODUCTION, ORDERS, INVENTORIES, AND LEADING INDICATORS

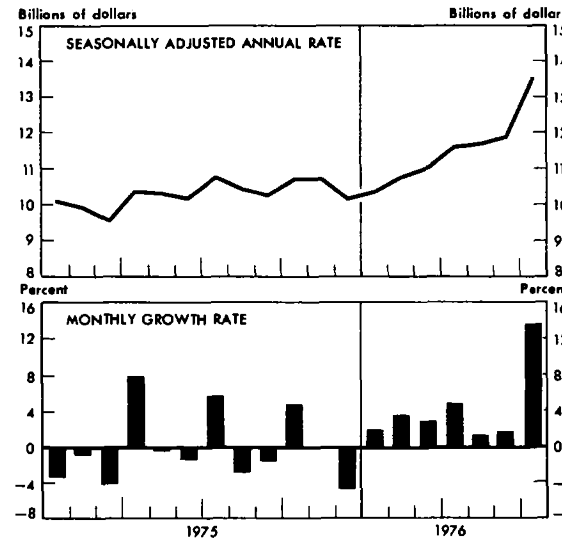
Industrial production inched ahead a scant 0.2 percent in July, the smallest increase recorded since October 1975. Over the period from March 1975 through July 1976 covering the first sixteen months of the economic recovery, industrial output climbed a healthy 12.6 percent at an annual rate. In more recent months, however, the growth of production has slowed noticeably, largely reflecting the ebbing in consumer demand and, to a lesser extent, the rubber and coal strikes. The slowdown appears to be broadly based among sectors. Output of consumer goods, after rising at a 14.9 percent annual rate from March 1975 to May 1976, remained unchanged over the three-month period ended in July. This production adjustment coincided with the midsummer lull in consumer buying and with efforts by businessmen to keep inventories lean. Production of business equipment has increased only modestly in recent months, and the output of intermediate products and materials has followed a basically similar pattern. In July, strike activity retarded coal mining and the production of motor vehicles and parts was significantly reduced. The outlook for auto production, however, is good. In the second half of the year, domestic auto manufacturers have programmed production at 4.2 million units, close to the record 1973 rate.

New orders received by durable goods manufacturers fell in July, but the decline can be attributed to an exceptionally large drop in defense-related capital goods orders. Other sectors generally showed strength. The sharp drop in defense orders appears to be related to the delayed beginning of the 1977 fiscal year for the Federal Government. In previous years, the Department of Defense placed a large number of orders at the end of the fiscal year, which were registered in the July data. As a consequence, seasonally adjusted orders for July typically lie well below unadjusted figures because seasonal adjustment procedures are designed to eliminate the impact of regular periodic movements. This July is unique, however, because of the change in the Federal Government's fiscal year. As part of the fiscal changeover, a transition quarter has been instituted, effectively delaying the end of fiscal 1976 until October. This has reduced the reliability of the seasonal adjustment factors, especially in July, and increased the likelihood of a sharp spurt in seasonally adjusted new orders for defense equipment occurring in the fall.

The book value of manufacturing and trade inventories increased sharply in June, rising by $3.5 billion. To at least some extent, it appears that the inventory buildup was unintentional and reflected the impact of recent slackening in the growth of consumer demand. Inventory building continued in the manufacturing sector during July, with nondurables accounting for most of the accumulation. Nondurables shipments advanced in line with inventories, however, and the inventory-shipments ratio was little changed in that sector. The pattern differed in durables manufacturing, where a marked drop in shipments combined with a modest $223 million increase in inventories to cause a jump in the inventory-sales ratio. Overall, the book value of manufacturing inventories increased nearly $870 million in July and shipments advanced only slightly, resulting in a third consecutive monthly increase in stocks relative to sales.

The Commerce Department index of leading indicators continued to signal underlying strength in July as it advanced 0.5 percent, its seventeenth consecutive monthly gain. Six of the eleven components of the index available thus far showed improvement, including residential building permits and contracts and orders for new plant and equipment. Reflecting the weakness in consumer spending, manufacturers' new orders for consumer products and materials appeared among the five components of the index of leading indicators that moved adversely. Though recent gains have been moderate, the direction of movement in the indicators remains unmistakable and serves to underscore the continuing momentum of the recovery.

Chart I
NEW ORDERS FOR NONDEFENSE CAPITAL GOODS



Source: United States Department of Commerce.

CAPITAL SPENDING AND CORPORATE PROFITS

Prospects for a pickup in business spending on fixed capital appear, on balance, to be brightening. To be sure, in most industries, capacity constraints are not a concern at this point but, because of the long delay between planning and the eventual arrival of capital projects on stream, businessmen appear to be looking ahead to production requirements in 1977 and 1978. New orders for nondefense capital goods jumped by a record amount in July, marking the seventh consecutive monthly gain (see Chart I). Propelled by the large July increase, these orders have risen 32 percent since the end of 1975. Because of the lag between orders and shipments, this advance should strengthen spending on producers' durable equipment into 1977.

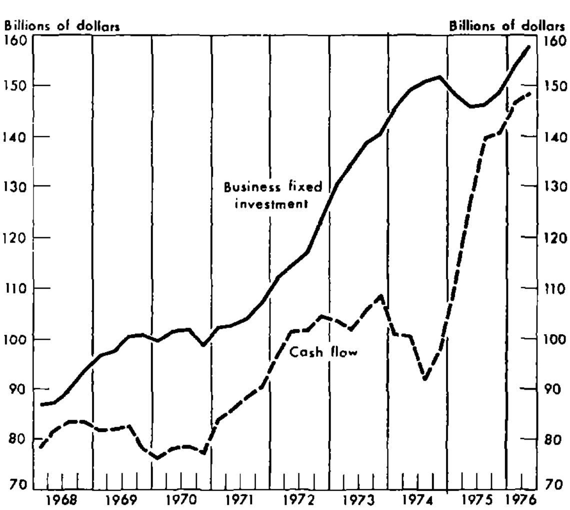
The most recent Commerce Department survey of planned plant and equipment spending indicates a 7.4 percent increase in such outlays over 1976 as a whole. While this represents little change in plans from the previous survey conducted in the spring, second-quarter spending fell short of expectations. Planned expenditures in the second half of the year have been marked up, especially in the fourth quarter. In a separate survey conducted by The Conference Board, the nation's 1,000 largest manufacturers increased new appropriations for plant and equipment 13.2 percent in the second quarter. Since appropriations are the first step in the investment process, the advance recorded by the latest Conference Board survey provides the basis for increased outlays over coming quarters. Moreover, the gain would have been substantially larger had it not been for a drop in appropriations by petroleum companies. Oil companies have been reluctant to expand capital outlays both because of concern over slim profits and because of price controls on domestic production.

Prospects for increased capital spending are also supported by the turnabout of retained earnings available to finance additional outlays that has occurred during the recovery. Revised data indicate that nonfinancial corporate cash flow—the sum of capital consumption allowances and aftertax profits—rebounded 61 percent since its cyclical low in the third quarter of 1974, while business fixed investment gained only 4.6 percent over the same period (see Chart II). The improved cash flow situation, caused mainly by a strong surge in profits, both increases the attractiveness of investment in new plant and equipment and reduces firms' dependence on outside sources of finance. The impact of this turnabout on investment spending was blunted in 1975 by the presence of extensive spare capacity. Moreover, firms tended to adopt the attractive alternative of debt retirement, thereby creating improved balance-sheet positions. But now, with debt burdens somewhat reduced and firms looking to capacity requirements in 1977 and beyond, the availability of ample internal funding will greatly facilitate needed expansion.

Underlying in part the expected growth in fixed investment outlays for the rest of 1976 are mandated expenditures for pollution abatement. These growing expenditures, amounting to more than 5 percent of total business fixed investment, have served to shore up investment spending during the recession and should contribute some momentum on into 1977. Of course, this additional expenditure normally does not increase productive capacity.

Chart II

CASH FLOW AND BUSINESS FIXED INVESTMENT



Note: Cash flow is measured after taxes and includes inventory valuation and capital consumption adjustments.

Source: United States Department of Commerce, Survey of Current Business.

PERSONAL INCOME AND CONSUMER DEMAND

Personal income posted a strong 1 percent increase in July, the largest rise since October 1975. A major part of the jump was due to higher social security payments which resulted from a midyear cost-of-living increase of 6.4 percent. At the same time, wage and salary disbursements to workers in the private economy rose sharply. This advance reflected gains in employment and higher average hourly earnings. On the near horizon, Federal Government employees' wages and salaries may receive a boost this fall from a proposed pay hike of nearly 5 percent.

The advance report of retail sales suggested an ebbing in consumer demand through July. Retail sales declined in that month and have been essentially flat since April. After adjustment for the impact of higher prices, it appears that consumers have actually retrenched in recent months. Nevertheless, the latest surveys suggest that consumer confidence continues to improve, and the recent rapid growth of personal income should provide some impetus to consumer spending in the period ahead.

The overall outlook for residential construction remains clouded. While ample mortgage money is available, borrowing costs have held at high levels. The multifamily sector in particular is still substantially depressed. True, the prospects for multifamily building appear to have improved, as rental vacancy rates remain much below 1975 levels and the absorption rate of newly completed apartments has risen, but profit margins continue to be squeezed by higher maintenance, repair, and construction costs. As a consequence, the incentive to build is generally not strong. In contrast to the lackluster multifamily sector, the recovery in single-family housing starts has pushed to more than 1.1 million units in recent months, considerably above levels that prevailed a year earlier. Single-family starts, however, have leveled off at this plateau. This leveling may be due, in part, to builder concern over relatively high stocks of unsold homes. Merchant builders' sales of new one-family homes have moved erratically in recent months. At the same time, inventories of unsold homes have been edging up so that, at current sales rates, inventory stocks represent about nine months of sales.

PRICES, WAGES, AND THE LABOR MARKET

The recent pattern of changes in consumer and wholesale prices has been roughly in line with the experience of the preceding two or three months. Consumer prices, for example, advanced at a 5.6 percent annual rate in

July, just a little below the 6 percent rise posted over the three-month interval ended in June. Prices for food climbed at only a 1.3 percent rate in July. On the other hand, the prices charged for consumer fuel and power jumped substantially. Leaving the volatile food and energy components aside, consumer prices rose in July at a 6 percent rate.

Wholesale prices, seasonally adjusted, rose at a 2.6 percent annual pace over the three months ended in August. This relatively moderate increase was heavily influenced by large outright declines in the prices of farm products and processed foods and feeds. Wholesale prices of industrial commodities, normally less volatile than farm prices, climbed at a rate of 7.6 percent over the same period, spurred by increases in metals prices and in energy-related items. Though wholesale prices of crude materials excluding foods and feeds jumped substantially during June and July, in August this spurt cooled. Overall, the evidence suggests that future price increases may be close to recent experience. The National Association of Purchasing Management reports that most purchasing executives anticipate only moderate to slight increases in the prices they pay. Given the promising agricultural outlook, it is likely that food prices will behave favorably while energy prices may well move adversely.

Throughout the first half of 1976, the rise in private nonfarm business-sector unit labor costs has been well below the underlying trend rate of increase in consumer prices and has thus exerted a moderating influence on the overall rate of price increase. Unit labor costs rose at an annual rate of 3.3 percent in the second quarter, close to the 3.5 percent first-quarter pace. Though increases in unit labor costs have been quite moderate, compensation per hour worked advanced at a 9.1 percent annual rate in the second quarter, down a bit from 9.5 percent first-quarter gains. These substantial pay increases were offset by brisk productivity gains, as output per hour worked in the private nonfarm business sector advanced at a 5.8 percent rate in the first quarter and this pace fell off only slightly to 5.6 percent in the second three months of the year.

The labor market situation was little changed in August. Reflecting the slowdown in the growth of real output, total employment edged ahead at an annual pace of only 1 percent. Although labor force growth slowed after its oversize July spurt, a sufficient number of new workers entered the labor market to push the unemployment rate up from 7.8 to 7.9 percent. Increased unemployment was not evenly spread across labor market groups. Among persons less than twenty-five years of age, there was a substantial increase in the rate of unemployment, with teenage unemployment—a volatile component—recording its largest rise since January 1975. On the other hand, there was an encouraging August reduction in the rate of joblessness among those aged twenty-five and over. Still, even among these groups, there has been some slippage, on balance, over the previous few months. Moreover, the percentage of persons claiming extended unemployment of over fifteen weeks duration, which had fallen from 3.2 percent of the labor force last winter to 2.1 percent this spring, has risen for three months and now stands at 2.5 percent.