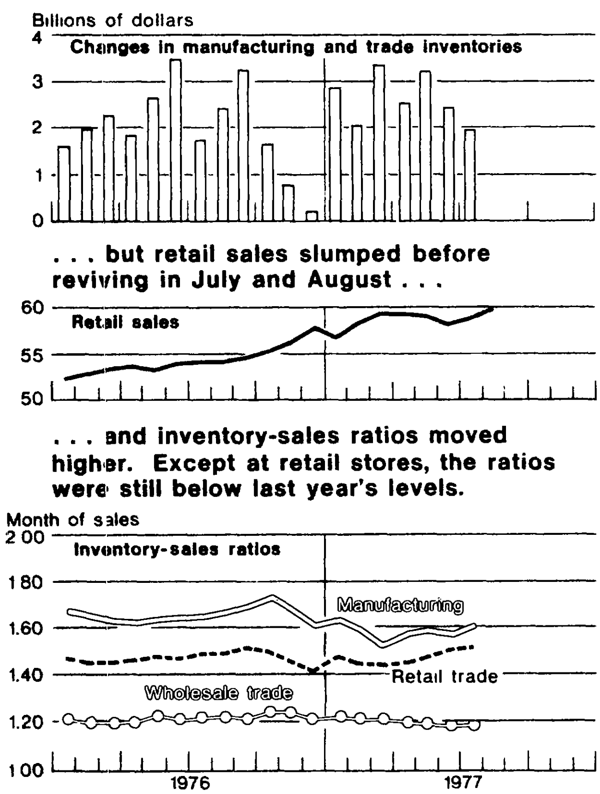
The business situation
Current developments

Manufacturing and trade inventories continued to grow at moderate rates during the spring . . .



All data are seasonally adjusted
Source: Department of Commerce

The United States economy has shifted into lower gear since the unusually rapid advance of the first half of 1977. With less robust demand conditions and, more importantly, with an easing of price pressures associated with last winter's prolonged freeze, inflation has also moderated. Some slowing of consumer spending during the spring and a subsequent mild inventory correction have apparently been primarily responsible for the slackening in the rate of economic growth. At the same time, however, there appear to be continuing elements of strength undergirding final demands for goods and services.

Inventory accumulation rebounded in early 1977 after a slowdown during the final quarter of last year. During the first three months of 1977, moreover, rapid accumulation of inventories was accompanied by even faster growth of final sales, so that inventory-sales ratios declined. Following an exceptionally sharp advance in March, however, retail sales edged lower during the spring while production of consumer goods continued to increase. The inevitable consequence was a moderate increase in inventories relative to sales, which occurred in the manufacturing sector as well as in retail trade (see chart). While most of the inventory building seemed to reflect management decisions, unintentional inventory accumulation appeared to accelerate as the spring wore on. By midyear, efforts to pare inventories were beginning to spread.

The need for adjustment seemed greatest in the nondurable goods sector. At the wholesale level, stocks of nondurables were reduced by successively larger amounts in May, June, and July. In the retail sector, stocks of nondurables rose substantially as sales sagged during the second quarter, but such inventories barely increased in July. Factory stocks of nondurables had risen rapidly in April and May but were reduced in June. Manufacturers of nondurable goods cut back substantially their stocks of materials and supplies again in July and August, while their inventories of finished products continued to build up.

Evidence of continuing efforts to pare inventories is reflected in other indicators of economic activity. Industrial production is estimated to have dipped 0.5 percent in August, the first decline in the total output of the nation's factories, mines, and utilities since the weather-induced drop last January. Output of consumer nondurable goods declined 0.7 percent, and production of furniture and appliances fell slightly. Employment in manufacturing showed no growth between June and September, while the average factory workweek fell from month to month The latest survey of the National Association of Purchasing Management also indicates continued efforts to lighten stocks of purchased materials.

In general, recent developments strongly suggest a continuation of the cautious stance that business firms have taken toward inventory decisions throughout the recovery from the 1973-75 recession. Chastened by the serious economic and financial dislocations that were exposed by the most severe downturn in the post-World War II era, firms have reacted quickly to incipient signs of weakening of demand by cutting back orders before undesired inventory accumulation became seriously burdensome. While this pervasive caution has served as a restraining influence on production, it has also helped to foster a reasonably balanced expansion with good prospects for a relatively long life.

On the basis of presently available evidence, it appears that a comparatively mild adjustment will suffice to correct the inventory imbalances that built up during the summer lull in retail sales. As of July, inventory-sales ratios in most sectors except retail trade were well below those prevailing last fall, on the eve of the inventory correction in the closing months of 1976. Retail inventories in July were higher in relation to sales than at any time last year. In view of the strong advance in retail sales in August, together with the decline in output of consumer goods, the retail inventory-sales ratio very likely declined in that month, although pockets of excessive stocks undoubtedly persisted.

Actual inventory-sales ratios, of course, depend only partly upon deliberate investment decisions. They also are affected by sales results that may or may not accord with business executives' expectations. A precipitate drop in sales could lead to a sudden unexpected run-up in stock-sales ratios. It could, moreover, make inventories that formerly were satisfactory in relation to sales expectations suddenly seem excessive. While such a dramatic turnaround in business fortunes can never be ruled out entirely, it appears unlikely to occur in the near future. As indicated in the article beginning on page 19, the financial sector looks to be generally free of the imbalances and strains that usually precede an economic downturn.

Even as the inventory adjustment has continued, moreover, signs of strength in final demand remain extensive Retail sales, after edging lower during the spring, rose 0.9 percent in July and 1 7 percent in August, according to the advance report. While the growth of personal income has slowed since the first quarter, consumer spending is being supported in part by the June reduction of withholding stemming from the increase in the standard deduction for the Federal individual income tax, as well as by the 5.9 percent cost-of-living increase in social security benefits beginning in July The incomes of 3.4 million Federal white-collar and military personnel, moreover, will be boosted in October by the 7.05 percent pay hike approved by President Carter.

Residential construction activity continues to move up. Private housing starts in July and August averaged an annual rate of 2.05 million units, 39 percent above the year-earlier level. Single-family housing starts have plateaued at a near-record annual rate of 1.44 million units during the past seven months, but apartment construction has been picking up. Multifamily housing starts averaged 600,000 at an annual rate in July and August, nearly double the year-earlier rate. Construction of multi-unit structures is still running at barely half the rate of 1972 Strong demand for housing, low rental vacancy rates, ample availability of mortgage financing, and stepped-up Federal rent supplement programs suggest further increases in construction of multi-unit housing A near-term advance may have been signaled by the sharp rise in building permits issued in August for multifamily units.

Business investment in plant and equipment, a laggard in the current economic recovery as compared with earlier postwar cycles, shows signs of strengthening The latest survey of plant and equipment spending plans, taken by the Commerce Department in July and August, indicates a 13.3 percent expansion of such spending this year over last year. Eliminating the effects of inflation, capital spending is estimated to increase 8 percent this year in real terms. The most recent survey represents the fourth in a series of Commerce Department surveys of 1977 capital spending intentions In each successive query, such spending plans have been revised upward, albeit in modest steps. Looking further ahead, a brisk pace of capital spending in the manufacturing sector is suggested by the Conference Board's survey of capital appropriations by the 1,000 largest manufacturers In the first half of 1977, newly approved appropriations—which typically lead actual spending by about a year—were running more than 20 percent ahead of the year-earlier pace in real terms.

Government expenditures on goods and services contributed significantly to the growth of real gross national product in the second quarter of this year for the first time in one and a half years. It is likely that public sector demands will continue to be stimulative. Advance indicators of defense spending point to higher outlays for defense, and bumper crops of grains promise to swell Government crop purchases under price support programs. At the state and local government levels, rapidly rising tax receipts and inflows of revenue-sharing funds under the Tax Reduction and Simplification Act of 1977 enhance the prospects of additional stimulus to demand from this sector.

Despite the abundance of elements of strength in the economy, the declines in retail sales during the spring and the subsequent production cutbacks prompted by efforts to keep inventories under control have arrested the decline in unemployment. The overall rate of unemployment had dropped sharply from 8 percent in November 1976 to 7 percent in April 1977. Since then, the rate has hovered about the 7 percent level, as moderate increases in employment have been approximately matched by increases in the labor force. Unemployment remains very high by historical standards, especially among blacks and other minorities and, most particularly, among minority youths. This situation constitutes a serious problem, especially in the large cities with heavy concentrations of minority persons. Much of this unemployment is "structural" and does not result simply from an inadequacy of aggregate demand. Indeed, as discussed, in the article beginning on page 14, a number of legislative and other structural changes have seriously compromised the usefulness of the unemployment rate as an indicator of demand pressures in the economy. A more reliable indicator of demand pressures may be found in the percentage of the population with jobs. The percentage of the noninstitutionalized population aged 16 years and over that was employed stood at 57.3 percent in September, up from 56.1 percent a year earlier and only 0.1 percentage point below the record high reached in early 1974 shortly after the peak of the last business expansion

The rate of inflation has moderated considerably since the rapid increases of the early months of the year. Wholesale prices of farm products and processed food and feed fell sharply during June through August. Relief at the retail level was felt in July and August, when food prices rose only modestly after having climbed sharply during the first half of the year. The rate of increase in consumer prices of commodities other than food has also slowed in recent months to an annual rate of 3.8 percent during the six months ended August 1977, compared with 6 percent during the preceding twelve months.

Recent price developments doubtless understate the ongoing rate of inflation. Government price supports maintain a floor under grain prices. In reaction to plummeting farm income, moreover, the Administration has ordered a 20 percent reduction in wheat acreage next year and has proposed a new grain stockpile. Continuing wholesale price increases in industrial commodities, averaging 6 percent at an annual rate so far this year, are likely to be felt in consumer prices eventually. And upward pressures on costs are unlikely to relent in coming months. Unit labor costs in the private business sector rose almost 7 percent during the four quarters ended mid-1977. The increases already legislated in payroll taxes and the boost in the minimum wage next January will add significantly to unit costs. As long as such cost pressures persist, they will tend to limit any improvement that can be expected in the underlying rate of inflation.