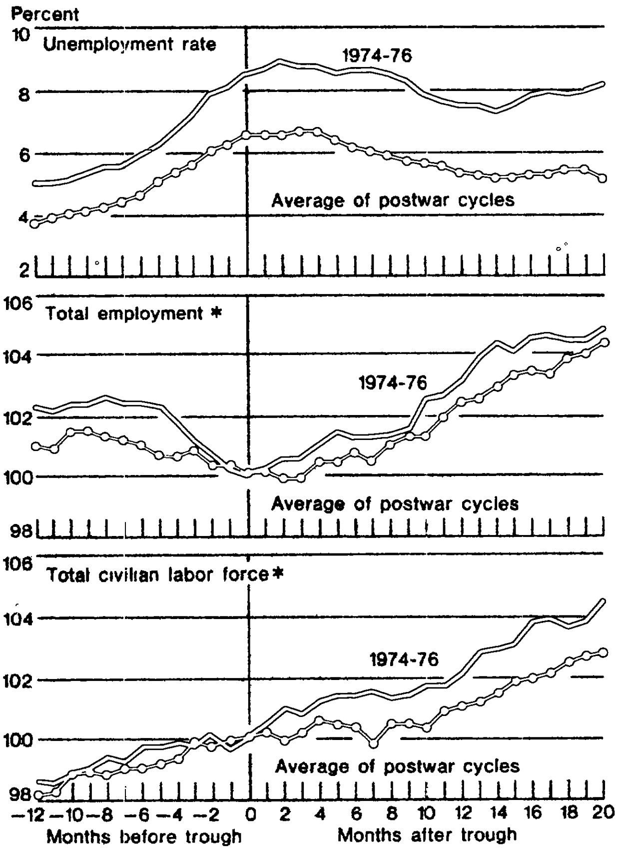
The business situation
Current developments

Chart 1
The Labor Market in Recession and Recovery



Note Recession troughs are dated according to National Bureau of Research chronology as occurring in May 1954, April 1958, February 1961, November 1970, and (tentatively) March 1975

* Indexed as a percentage of the trough-month level for each respective cycle

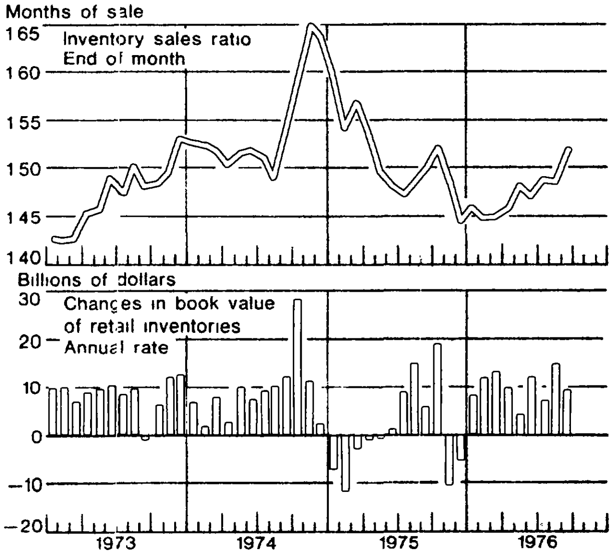
Source. United States Department of Labor, Bureau of Labor Statistics

The prolonged "pause" in the rate of economic advance appeared to have continued into the fourth quarter. The economy's resistance to the resumption of a more vigorous rate of expansion has necessarily increased uncertainties over the outlook. Nevertheless, the danger of the economy moving into outright recession in the near future seems small. The current recovery is still relatively young by the standards of postwar business cycles and thus far has been marked by few of the stresses and strains that typically precipitate downturns. Indeed, the current episode of consolidation could lay the foundation for a prolonged period of gradually increasing prosperity.

The pace of the recovery from the 1973-75 recession has not been abnormal, compared with other economic recoveries since the Korean war. Measured from the apparent trough in the first quarter of 1975, real gross national product (GNP) increased 7.3 percent during the first four quarters of recovery. This gain was slightly faster than the average increase of 7 percent during the first year of the four preceding cyclical recoveries—those beginning in 1954, 1958, 1961, and 1970. Even the much discussed "pause" in the rate of expansion during the past two quarters was normal. The 4.1 percent annual rate of real GNP growth during the second and third quarters of 1976 was actually slightly faster than the 3.7 percent increase averaged during the second year of the four preceding recoveries. Hence, another quarter or two of slowdown in the rate of economic growth would not be at all unusual and would not necessarily presage an early end to the expansion. Only one of the four previous periods of expansion was as short as eight quarters; the average length was seventeen quarters.

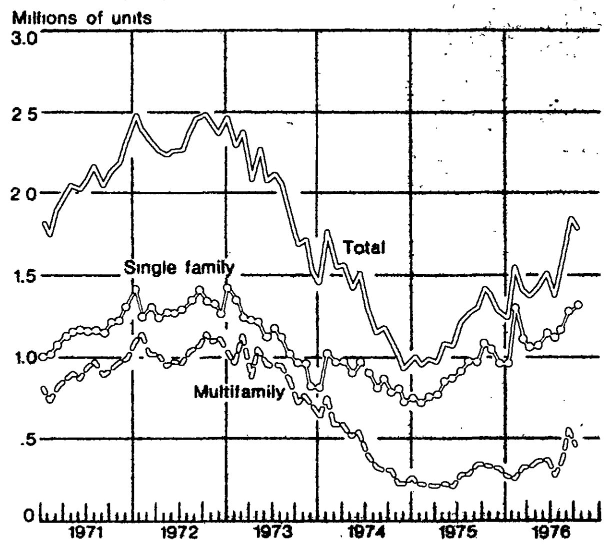
What is distinctive about the current recovery is the relatively low rate of resources utilization. The newly revised Federal Reserve Board index of manufacturing

Chart 2
Retail Inventories
Seasonally adjusted



Source United States Department of Commerce, Bureau of Economic Analysis

Chart 3
Private Housing Starts
Seasonally adjusted annual rates



Source: United States Department of Commerce, Bureau of the Census.

capacity indicated a utilization rate of 79.8 percent in October, 8 percentage points below the recent peak in the third quarter of 1973. At a comparable stage of the four preceding cyclical recoveries, capacity utilization in manufacturing averaged close to 84 percent according to this measure (see the article on pages 13-20 of this *Review).* Much more striking is the underutilization of manpower. The unemployment rate was 8.1 percent in November, only 0 8 percentage point below the recent high reached in the spring of 1975. After twenty months of expansion in the four previous cycles, the unemployment rate averaged 5.1 percent, which represented an average decline of 1.6 percentage points from the respective cyclical peaks in the unemployment rate (see the top panel of Chart 1).

The persistence of high rates of unemployment has not resulted from unusually slow growth of employment during the current recovery. Indeed, as may be seen in the middle panel of Chart 1, total employment has increased somewhat more during the current recovery than on average during the four preceding recoveries. In large measure, the current high rate of unemployment reflects the severity of the last recession, which pushed the jobless rate to the highest level since World War II. It also reflects the unusually rapid growth of the labor force during much of the current expansion. As can be seen in the bottom panel of Chart 1, the total civilian labor force increased 4.4 percent during the first twenty months of the current recovery, which was much faster than the 2.7 percent average increase during the comparable period of the last four recoveries. Another influence contributing to the high overall rate of unemployment has been the continuing shift in composition of the work force toward groups that characteristically experience relatively high rates of unemployment (see the article on pages 24-30 of this *Review).*

The stumbling of the economy early in the fourth quarter was exemplified by developments in industrial output. After advancing for seventeen consecutive quarters, industrial production, as measured by the Federal Reserve Board's index, dipped slightly in September and then declined by a more pronounced 0.5 percent in October, according to preliminary data. While the September dip largely reflected the effects of the strike of the United Auto Workers against the Ford Motor Company, the October decline was more generalized Declines in production were common among materials and manufactured products, including business equipment and consumer goods. These production cutbacks undoubtedly reflected attempts of firms to trim inventories, or to keep inventories from increasing, in the face of disappointing sales.

A periodic data revision released in November indicated that the level of retail inventories was about 3½ percent higher than previously thought. While the September rise in stocks was not unusually large, sales slipped and the ratio of retail inventories to sales rose to the level of April 1975 when the economic recovery was just getting under way (see Chart 2). Inventory excesses in some lines are suggested by scattered indicators such as preseason sales of various consumer goods and rebates on some subcompact automobiles. However, existing excesses appear neither widespread nor overwhelming. Most firms seem to feel they have their stocks under reasonable control, and the swiftness with which firms cut back orders when stocks appear to be getting out of line should help prevent inventory excesses from cumulating. If demand were to fall off drastically, however, the picture could turn around abruptly—as happened in late 1974.

The likelihood of a sharp drop in demand appears slim. Indeed, while there are no conclusive signs of a rejuvenation of the economic expansion, a number of indicators point in that direction. Retail sales rebounded in October and November after several months of sluggishness. Nonfarm payroll employment posted a sizable increase in November, as did hours of overtime and the average workweek in manufacturing. Housing starts and permits rose sharply in September and held on to most of those gains in October. Especially impressive was the performance of single-family home building. Single-family home starts in October were only a shade below the best months of 1972 and early 1973 (see Chart 3). Ample funds are available to finance increased homebuilding activity, as banks and thrift institutions continue to enjoy large inflows of savings attracted by deposit rates that are more generous than returns available on short-term market obligations such as Treasury bills (see article on pages 33-39 of this *Review*). Capital spending by business is another sector that may be poised for a significant advance. Several early private surveys indicate an increase in planned outlays for plant and equipment of about 6 to 7 percent in real terms in 1977. Continued sizable increases in new orders for capital goods appear to be consistent with these plans, although the Commerce Department's survey of plant and equipment spending plans for the first half of 1977 suggests a smaller rate of advance.

One development that could deal a severe blow to the nation's economic expansion would be a resurgence of accelerating inflation, but it appears that such a resurgence can be avoided. The United States has made great strides during the past two years in reducing inflation. As measured by the consumer price index (CPI), for instance, the rate of inflation has been reduced from 12 percent in 1974 to 5½ percent during the past year. To a considerable extent, however, this impressive record reflects the winding down of a combination of extraordinary developments that pushed prices sharply higher in 1973 and 1974. Further progress in reducing inflation is likely to be much more gradual and more difficult to achieve. The 0.3 percent increase in the CPI in October probably understated the ongoing pace of inflation. The overall index was held down by stable food prices which translated into a very modest price rise after seasonal adjustment. Such stability in food prices cannot be expected to continue indefinitely, although the Department of Agriculture foresees only a moderate rise at least through mid-1977. The remainder of the CPI increased in October at an annual rate of 5½ percent, the same as the growth rate of the overall index during the past four quarters.

If the CPI numbers for October tended to understate the ongoing rate of inflation, the wholesale price index (WPI) for the past several months has almost certainly exaggerated the strength of inflationary forces in the marketplace. During the past three months, September through November, prices measured by the industrial wholesale price index have increased an average of 0.9 percent per month. It might be recalled that a similar bulge at the same time last year was followed by several months of much more modest increases. There could be problems with the seasonal adjustment of these data, relating in part to the annual increases in new car and truck prices that accompanied the introduction of the new models as well as other factors. Nearly half the increase in industrial wholesale prices in October and November was accounted for by power and fuel. In large measure, these increases reflected the effects on energy prices of regulatory changes—the increase by the Federal Power Commission in ceiling prices for natural gas sold across state lines beginning in late July and the decontrol in September by the Federal Energy Administration of crude oil from certain marginal wells. Due to the usual reporting lags, as well as continuing adjustments of prices to these regulatory changes, the effects of these events showed up in the WPI in October and November. Reported prices of other industrial commodities rose an average of 0 5 percent per month, seasonally adjusted, during those two months. Because of the difficulties inherent in measuring actual transactions prices in periods of changing demand conditions, it is likely that the effective prices at which a number of industrial commodities actually traded—taking account of discounts and special allowances—were somewhat weaker than indicated by the WPI. Moreover, it is not certain that recent increases in posted prices of some metals and fibers will withstand the test of the market.