The Business Situation

There now appears little doubt that the economy is emerging from the most severe postwar recession. Revised estimates of gross national product (GNP) confirm that a turnaround in economic activity occurred in the second quarter.* Even more importantly, the latest readings of the monthly business statistics suggest that the nascent recovery has been picking up momentum. Consumption spending has provided the essential base of the recovery, both directly by adding to the demand for final goods and indirectly by facilitating the liquidation of excessive inventories. Indeed, the massive inventory correction seems to be diminishing, although some inventory imbalances remain in certain sectors. In July, new durables orders rose for the fourth consecutive month and industrial production climbed for the second consecutive month. To be sure, capital spending and residential construction are lagging, but the beginnings of a recovery in home building are visible. Moreover, recent developments in the labor market have been, on balance, encouraging. Although the civilian labor force increased sharply in August, the rate of joblessness remained unchanged from the July level as employment advanced strongly.

The price situation, however, has taken a turn for the worse. After having eased a bit in earlier months of the year, the rise in the consumer price index, propelled by bulges in food and energy prices, advanced more sharply in June and July. Moreover, wholesale prices rose rapidly in August, as fuel and power prices jumped. Further increases are in the offing for some foods and for oil, aluminum, steel, and automobiles, despite the pronounced slack that still remains throughout the economy.

*In contrast to the slight decline in real GNP in the second quarter that had been indicated by the preliminary estimate, the revised data show a modest advance of 1.6 percent at an annual rate, the first increase since 1973. Inventory liquidation was revised downward from the preliminary figure, while final sales were revised upward primarily as a result of an upward revision in net exports. Released along with the GNP revisions was a preliminary estimate of pretax corporate profits (adjusted for changes in inventory valuation). This estimate shows a rise of $6.2 billion during the second quarter to a $100.5 billion seasonally adjusted annual rate.

PERSONAL INCOME, CONSUMER SPENDING, AND RESIDENTIAL CONSTRUCTION

A $5.7 billion decline in personal income in July was the result of a special situation. The previous month, one-time payments of $50 had been made to recipients of social security, railroad retirement, and supplemental security benefits. These transfer payments had amounted to almost $20 billion at an annual rate, approximately three and one-half times the size of the July decline in total personal income. Wage and salary disbursements have been expanding in recent months, after having reached a nadir last February. In coming months, these disbursements should continue to rise, assuming employment continues to increase and the average workweek to lengthen. Aftertax income should grow even faster, as lowered withholding rates take effect in the second half of the year.

Consumption spending has recently been in the forefront of the recovery. Total retail sales increased $1.2 billion in July. Sizable advances had also been recorded in the preceding three months. As a result, for the four months ended July, growth amounted to 26 percent at an annual rate. Durable goods sales, led by a rebound in automobile sales, have accounted for the bulk of this upsurge in consumption spending. No doubt the recent gains in personal income, on an aftertax basis, have been a major factor in this advance. Just as important, but harder to measure, has been the diminution in the manifold uncertainties that have dogged consumers for some time, especially those related to inflation and employment prospects. This development may explain the appreciable improvement in consumer confidence recorded since late last year, as measured by the Conference Board and the Survey Research Center of the University of Michigan. It remains to be seen, however, what damaging effect the latest price acceleration might have on the growth of consumer spending. In any case, it seems clear that the recent strength in consumption spending has been instrumental in enabling retailers to pare their inventory stocks to the point where little imbalance, if any, remains in this sector. Thus, consumption spending is having a dual effect in stimulating the economic recovery.

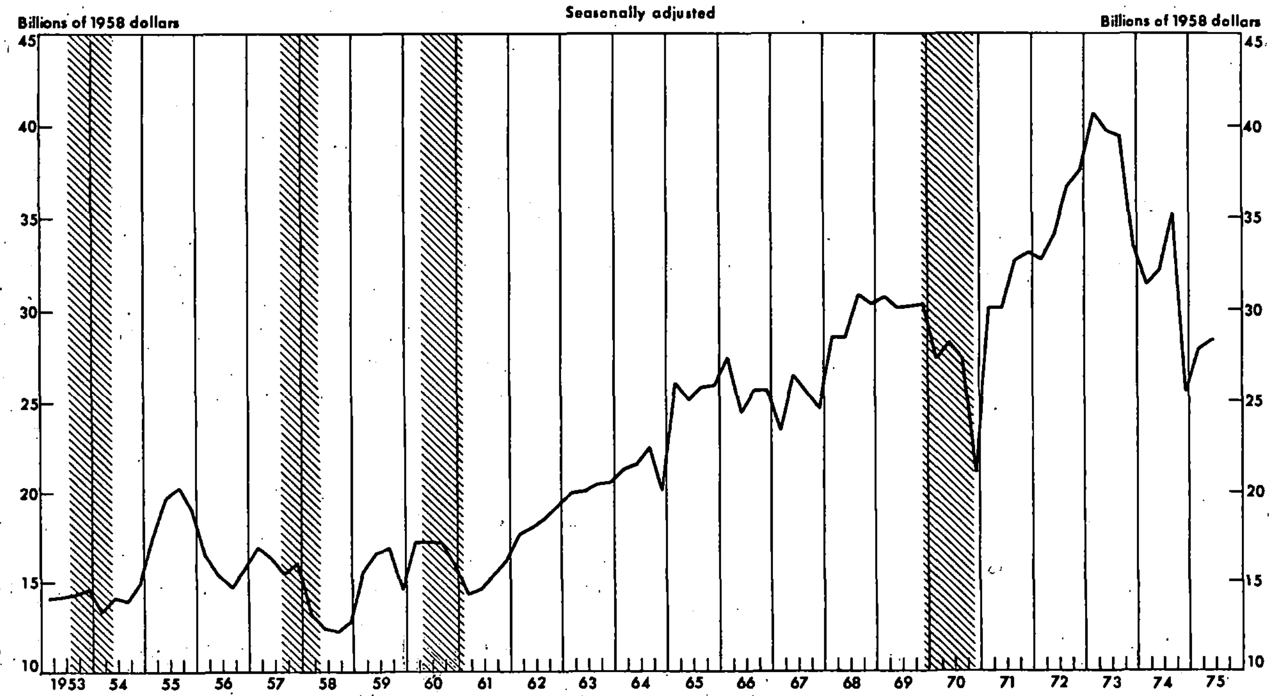
The sharp rebound in automobile sales in recent months is reminiscent of developments in past recovery periods (see Chart I). In the previous postwar cyclical recoveries, real consumer outlays on automobiles have increased, on average, about 37 percent over the twelve months following the trough. Whether new car purchases in the current recovery will fully conform to this historical pattern remains to be seen. Auguring a strengthening in the demand for new cars is the presumably growing need to replace the aging and less efficient stock of existing automobiles. However, the replacement decision is fundamentally an economic one, based on income and employment expectations and on the cost of purchasing and maintaining the car. In the latter regard, the recently announced price hikes on the new 1976 models, coupled with the prospect that the 1977 models will be more economical to operate, might well induce many car owners to postpone purchasing a new car until the 1977 models become available. Judging by their production schedules and tentative forecasts, the automobile manufacturers themselves do not appear to be overly bullish about sales prospects over the remainder of the year. In the event that purchases of the 1976 car models do not increase very much above those of the previous year, thus departing from the pattern of past recoveries, consumers can either save the retained purchasing power or spend it on other goods. Which option they choose will have a significant bearing on the scope of the economic recovery.

The long-awaited upturn in residential construction now appears to be getting under way. Housing starts rose to a seasonally adjusted annual rate of 1.24 million units in July, up 16 percent from the average rate of the second quarter and 41 percent above the low-water mark recorded last December. Whereas virtually all of the recovery in starts earlier in the year had been in single-family units, the July increase was centered in multiple-unit dwellings. Spurred in part by the 5 percent tax credit,

Chart I

CONSUMER EXPENDITURES ON AUTOMOBILES

Seasonally adjusted



Note: Shaded areas represent recession periods, indicated by the National Bureau of Economic Research (NBER) chronology. The latest recession has not yet been dated by the NBER.

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

sales of new single-family homes by merchant builders have risen substantially in recent months. Although such sales edged down a bit in June, they continued, as had been the case in the previous four months, to exceed the additional new homes put up for sale. As a result, the stock of unsold new single-family homes has receded to the lowest level in three years, and an increasing proportion of this inventory has come to represent homes under construction rather than completed dwellings.

Developments in the mortgage market have played a key role in the recent upturn in home building. The flow of deposits into thrift institutions in the last few months has been heavy, although it is uncertain that the inflow will continue at the recent high pace. In July, the savings flows amounted to a 17.8 percent seasonally adjusted annual rate, about equal to the growth over the first half of the year and almost three times as large as that experienced during the year ended December 1974. While the thrift institutions have, in turn, channeled a large proportion of these funds into securities, they have also been issuing mortgage commitments. Indeed, outstanding mortgage commitments of all savings and loan associations and mutual savings banks in New York State increased at a 63 percent seasonally adjusted annual rate from February to July, whereas they had actually decreased 26 percent over the twelve-month period ended February 1975. Since mortgage commitments must generally be secured before construction financing can be arranged, the recent growth in outstanding commitments suggests that home builders are currently planning to undertake a large number of new construction projects. However, while lending terms for new mortgages eased slightly early in the year, they currently are inching higher. Reflecting this increase in rates on conventional mortgages, the maximum allowable interest charge on Federally insured mortgages was raised at the end of August by ½ percentage point to 9 percent. In addition, at the Federal National Mortgage Association's auction held at the end of August, secondary market interest rates on four-month forward commitments for insured mortgages were 33 basis points above those of the previous month's auction.

INDUSTRIAL PRODUCTION, INVENTORIES, AND CAPITAL SPENDING

The Federal Reserve index of industrial production, which had advanced 0.5 percent in June, increased by an equal amount in July, bringing a halt to the 14 percent decline that had been registered between November 1973 and May 1975. Most of this contraction took place between September 1974 and February 1975, as firms throughout the economy struggled to get out from under the huge overhang of excess inventories. Early in 1974, manufacturers had engaged in an all-out effort to rebuild their stockpiles of raw materials and intermediate products, items that had been in extremely short supply at the end of 1973. As this replenishing was going on, however, the aggregate demand for final goods faltered and then plunged. At that point, what had been an inventory shortage suddenly turned into a glut.

This past June, higher output of both consumer goods and nondurable materials finally more than offset continued declines in other sectors. Output of textiles, paper, and chemicals posted sharp rises in June and again in July, suggesting that inventory liquidation may be nearing completion in these industries. On the other hand, further declines in production of most durable materials and of business equipment indicate continued efforts to pare inventories. The iron and steel industry has been especially hard pressed; in July, output of iron and steel declined for the sixth consecutive month to the lowest level since 1971. In retrospect, it appears that the strong demand for steel in 1973 and through most of 1974 had depleted steel-mill inventories. Thus, when the demand by large steel customers dropped, part of the slack in demand was offset by the rebuilding of steel mills' own inventories. By October, however, the mills had restored their inventories of ingots and semifinished shapes, such as rods and wire. Iron and steel production then plummeted, at about double the rate for all other industries. Despite the continuing sluggish demand, several steel companies have announced that, to offset increased production costs, they intend to raise prices in early autumn. As a result, demand for steel has apparently picked up in an effort by mill customers to beat the announced price hikes.

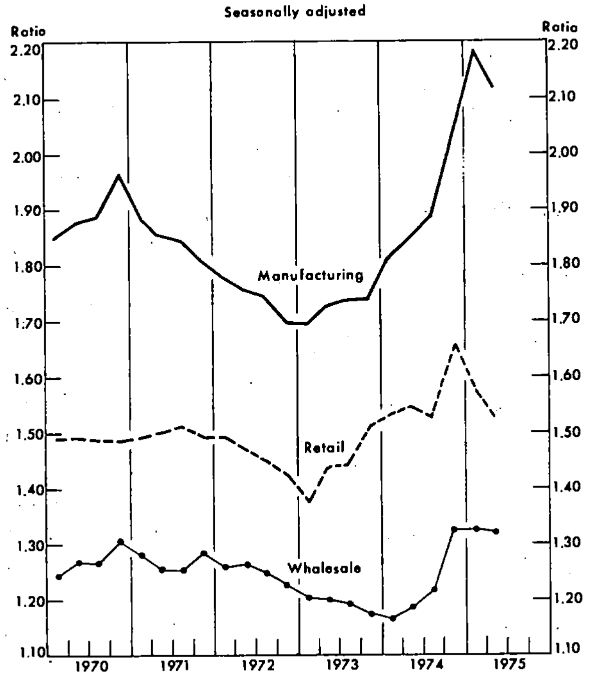
New orders received by durable goods manufacturers spurted in July by $1.7 billion, or 4.3 percent. The July advance was broadly based and marked the fourth consecutive monthly gain. Indeed, the expansion in new durables bookings between March and July amounted to 15 percent, far greater than the growth in production. As a result, the backlog of unfilled durables orders increased in July for the first time since September 1974.

While nonfarm businesses are probably still in the process of liquidating their inventory stocks, the pace appears to be slackening a bit. The reduction of excessive inventories had begun late last year in the wholesale and retail trade sectors, and had spread from there to the nondurables manufacturing sector and then to durables manufacturing. The liquidation in the retail trade sector seems to have diminished considerably. According to recent data on the book value of inventories, retail and

Chart II

RATIO OF REAL INVENTORIES TO REAL SALES

Seasonally adjusted



Sources: Inventories in constant 1958 dollars: United States Department of Commerce, Bureau of Economic Analysis. Sales in constant 1967 dollars: United States Department of Commerce, Bureau of the Census data deflated by the National Bureau of Economic Research. Inventory data converted to 1967 basis and ratios calculated by the Federal Reserve Bank of New York.

wholesale distributors, apparently encouraged by the rebound in sales, added to their inventories in June for the first time in the current year. Of late, however, the book value data have tended to be a rather unreliable indicator of inventory conditions. The accounting conventions used to value inventories give rise to distorted measurement during periods of inflation, regardless of whether it is a period of accelerating, decelerating, or steady inflation. Hence, to gauge the extent of inventory imbalance it is more useful at the present time to examine ratios of real inventories (i.e., inventories valued in constant dollars rather than book value) to real sales (see Chart II). Within the retail trade sector, the real inventory-sales ratio had backed off considerably by the second quarter of this year from the peak attained in the last quarter of 1974. On the other hand, hardly any improvement occurred in the real inventory-sales ratio for the wholesale trade sector, with the level in the second quarter just about equal to the cyclical peak. Moreover, substantial inventory imbalances continue to exist in manufacturing; inventories relative to sales fell only slightly in the second quarter after having reached exceedingly high levels earlier in the year. Monthly data on the book value of manufacturers' inventories indicate that the liquidation continued in July. Manufacturing inventories fell that month at an annual rate of $11.4 billion, with the bulk of the decline in the durable goods sector. Moreover, the August survey by the National Association of Purchasing Management indicates a further runoff in the stocks of purchased materials.

According to the Commerce Department survey taken in July and August, businessmen again lowered their planned expenditures on new plant and equipment. Capital outlays over the second half of 1975 now are projected to rise at an annual rate of only 1.9 percent. The weakening outlook for capital spending is also reflected in capital appropriations. As reported by the Conference Board's survey of large manufacturers, capital appropriations were slashed by 17.7 percent in the second quarter, marking the third consecutive quarterly decline and the largest cutback on record. While most manufacturers continued to reduce appropriations, automobile manufacturers raised the level of their appropriations by about 40 percent. This reflected the large retooling expenses associated with the changeover to the 1977 models.

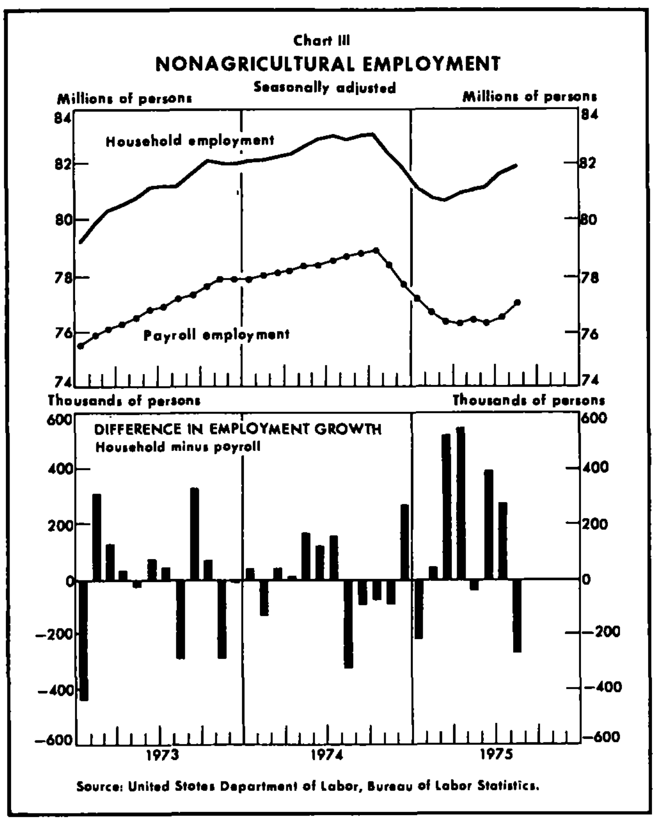
LABOR MARKET DEVELOPMENTS

The labor market showed signs of strengthening in August. Based on the household survey conducted by the Department of Labor, employment rose by 274,000 workers on a seasonally adjusted basis. With the civilian labor force growing by a comparable magnitude, the overall rate of joblessness remained unchanged at July's level of 8.4 percent. Over the five months ended August, the household survey has recorded an increase in nonagricultural employment of 1.3 million (see top portion of Chart III). However, the survey of establishments, the so-called payroll survey, shows a much less favorable employment situation, with an advance of only 667,000 workers. While month-to-month divergences between the two series are not infrequent, these divergences tend to be offsetting over longer periods (see bottom portion of Chart III). The large August gain of 528,000 workers in payroll employment helped reduce the discrepancy that had developed since March between the increases indicated by the two series. The percentage of industries recording employment increases rose above 70 percent, to the highest level since late 1973, underscoring the August pickup in payroll employment.

The divergent behavior in recent months of the two nonfarm employment series reflects, in part, differences in sample coverage. The household survey measures the number of persons holding jobs, while the payroll survey seeks to gauge the number of filled job slots. For example, a person holding two jobs would be counted twice in the payroll survey but only once in the household survey. Nevertheless, measured household employment is always greater than payroll employment, since the coverage of the household survey is more comprehensive. While both surveys count employed wage and salary workers, the household survey includes the self-employed, certain unpaid workers of family-operated enterprises, and private household workers, none of whom appear on establishment payrolls. Also, unlike the payroll count, the household survey includes unpaid absences associated with illness, bad weather, strikes, vacation, and other personal reasons. Although there are also other differences in coverage, the above discrepancies are usually responsible for most of the divergent monthly behavior of the two series. However, only some of these elements of disparate coverage can be readily quantified with published seasonally adjusted monthly data. In recent months, the measurable sources of disparity have fallen far short of accounting for the divergent movements in the two series.

Some of the remaining unexplained discrepancies between the two surveys arise from differences in sampling techniques and in collection and estimation methods. The household survey is gathered from a scientifically selected sample of about 50,000 households during the week that includes the twelfth of the month. The establishment survey, reflecting the payroll period that also includes the twelfth of the month, is based upon payroll reports from a sample of firms employing over 30 million wage and salary workers, roughly 40 percent of the estimated total number of workers on establishment payrolls. The large size of the payroll sample reduces sampling variability and results in a more stable monthly data series. Although both series are subject to similar seasonal fluctuations, the monthly patterns of the seasonal adjustment factors do differ somewhat and may contribute significantly to the disparity between the series. In addition, there are also other methodological details that can contribute to divergent monthly behavior of the two surveys.

During periods in which these major surveys are giving different signals, it is important to look at movements in other labor market indicators. Data on labor turnover rates in manufacturing, which are available only through July, suggest some improvement in the labor market. In July there was a jump in the rate at which new workers have been hired, marking the fourth consecutive monthly increase. At the same time, the layoff rate—the number of workers laid off in a month per 100 employees—fell to the lowest level since late 1974. Improving employment prospects are also reflected in the increase in the number of individuals voluntarily leaving their present jobs; in July, such quits exceeded the layoff rate for the first time since October. A gauge of the demand for labor in all industries is provided by the Conference Board's index of the volume of newspaper help-wanted advertising. While still low by historical standards, this index rose in July to its highest level in seven months.



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

THE PRICE SITUATION

Rapid inflation erupted again in July and August, propelled by a bulge in energy and food prices. Outside these troublesome sectors, price increases remained relatively moderate. But the near-term outlook for an easing of inflation is not very encouraging. Significant increases will probably occur soon for some foods and for oil, aluminum, steel, and automobiles.

After moderating for several months, consumer prices jumped sharply in June and July. In the latter month, the consumer price index rose 1.2 percent, the sharpest rate of increase in ten months. Food prices, led by price hikes on meat and poultry, surged. Consumer energy prices, primarily on gasoline and motor oil, also rose at extremely rapid rates. Excluding energy prices, nonfood commodity prices rose 0.6 percent. However, the announced increases in auto prices will soon be felt. There could be additional shocks to the consumer price index in the near future as a result of higher energy prices. This would occur if members of the Organization of Petroleum Exporting Countries increase their oil prices this fall. Although the legislation authorizing controls on prices of domestically produced "old" oil lapsed at the end of August, no sharp price increases have been posted—perhaps reflecting expectations of the imminent reimposition of controls for a temporary period. Prices would be expected to rise, however, if a program of gradual decontrol were to be enacted. Such a program might well be accompanied by an excess profits tax on oil companies and by tax credits to consumers to offset, at least partially, the impact of higher prices. In these circumstances, the resulting increase in the consumer price index would exaggerate the inflationary impact on consumers, since fuel costs are a direct component of the consumer price index whereas taxes (and tax credits) are not.

At the wholesale level, prices rose in August at a 0.8 percent seasonally adjusted rate. Prices of fuel and power continued to accelerate, increasing at a rate of about 3 percent; part of this upsurge probably reflects the recently enacted import fees on crude oil and refined petroleum products. Industrial commodity prices other than power and fuel rose 0.3 percent. Over the six months ended August, these prices have risen at an annual rate of only 1.5 percent. Prices of farm products and processed foods and feeds declined nearly 1 percent in August, after having jumped the month earlier. This turnaround was led by prices of fresh meats and vegetables.

Over the four weeks ended August 26, the Bureau of Labor Statistics index of basic commodities jumped 3.5 percent. Industrial commodity prices rose 6.9 percent, as prices surged in mid-August, led by price increases for lead and steel scrap. It is possible, however, that to a large extent the advances in these metal prices was the result of buyers hedging against higher future mill prices. Thus, it need not be expected that these prices will continue to shoot up. Prices of raw foodstuffs have edged down in recent weeks. Improved growing conditions have raised prospects for corn and wheat production, although concern over increased foreign demand for United States exports remains. The latest Department of Agriculture estimates now suggest that carry-over stocks of these key crops may increase only slightly.