The Business Situation

Economic activity has advanced sharply in recent months, but the upward impetus is still rather narrowly based. In the third quarter, the increment in gross national product (GNP) in real terms was the largest in twenty years. Over half of this gain, however, was attributable to the marked slowdown in the rate of inventory liquidation. Expansion in consumption spending, especially on durable goods, accounted for the rest of the increase. Elsewhere, there was barely any movement, as the small increases and decreases recorded for the other components of real aggregate demand were largely offsetting. Nor are there any clear-cut signals of developing strength in these other spending components. Looking ahead, once the inventory imbalance has been eliminated, it appears that the pace of the economic recovery will for a time be keyed closely to the growth in consumption spending.

While there continues to be a good deal of variability in the monthly price data, the overall rate of inflation was about 7 percent at an annual rate in the third quarter. This is a bit higher than the rate of inflation in the previous quarter but is still a substantial improvement over the double-digit increases recorded last year. However, the acceleration of wholesale industrial commodity prices in the past six months, together with the flare-up of these prices in October, is a worrisome development which suggests that the prospects for a significant slowdown in the near term are anything but certain. Whereas the huge overhang of inventories had fostered some moderation in price increases earlier in the year, this imbalance has been largely eliminated. Moreover, after having tapered off a bit, the rate of growth of wages appears to have quickened somewhat in recent months, and fuel and energy prices have been rising at a slightly faster pace.

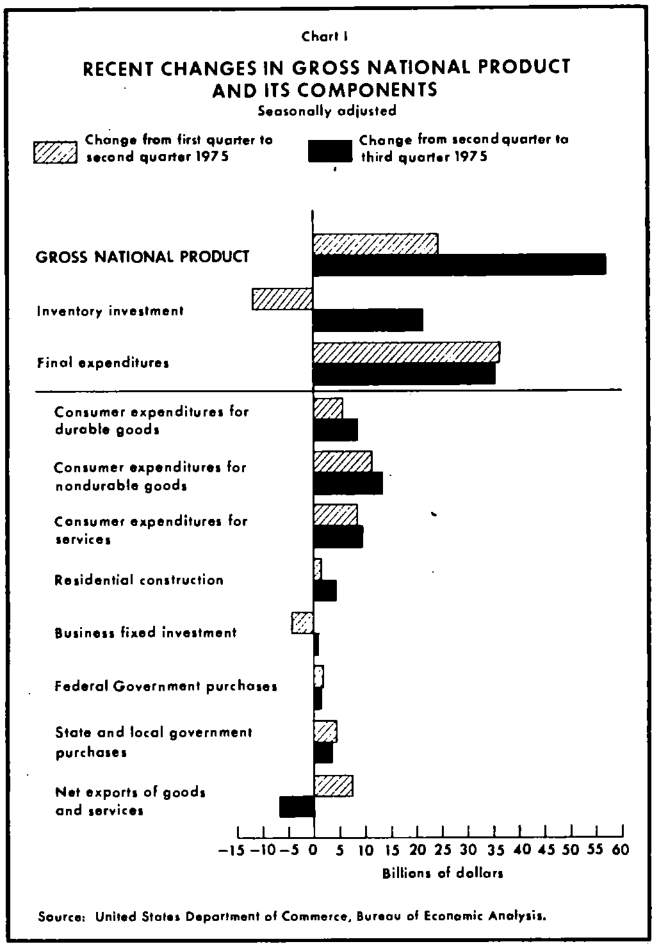
GNP AND RELATED DEVELOPMENTS

According to preliminary estimates compiled by the Department of Commerce, the market value of the nation's output of goods and services (GNP) rose in the third quarter at a 16.8 percent annual rate of increase. Measured in terms of 1958 prices to correct for changes in the price level, the increment in real GNP amounted to a hefty 11.2 percent rate, up from the 1.9 percent rise of the previous quarter and the biggest quarterly gain in twenty years. Nevertheless, real GNP was still almost 5 percent below the peak recorded at the end of 1973.

Contributing most to the third-quarter surge in GNP was the sharp slowdown in the pace of inventory liquidation (see Chart I). Indeed, the slower runoff of business inventories accounted for more than half of the total gain in real GNP. In fact, the monthly data on the book value of business inventories (which are, however, measured differently than in the national income accounts) showed a sizable accumulation occurring in August for the first time since last January. Moreover, the August increase was broadly distributed throughout the trade and manufacturing sectors, the only exception being in the durables manufacturing industries. This pattern suggests that much of the inventory overhang has now been eliminated. Further corroborating evidence can be gleaned from the recent behavior of the ratio of real nonfarm business inventories to real final sales of the business sector. This ratio jumped to a record peak at the end of 1974; since then, it has declined steadily to about the level of the first half of last year. While imbalances still exist within certain segments of the economy, notably the durables manufacturing sector, it does look as though the inventory liquidation process will have run its course in the next few months. Once the inventory correction has been completed, the speed of the economic recovery will then be paced by the strength in real final sales.

In the third quarter, final expenditures—equal to GNP less the change in business inventories—moved ahead at a 4.4 percent annual rate in real terms, just about equal to the growth of the previous quarter. The sizable advance in consumption spending more than accounted for the increase in real final sales. Among the other components of aggregate demand, there were small increases and decreases which were largely offsetting, on balance.

Buoyed by the vigorous economic recovery, the one-shot 1974 tax rebates, the special payments to recipients of social security, and the 1975 tax reductions, disposable personal income has staged a fairly strong comeback since



the beginning of the year in real terms. As of the first quarter, real disposable income had fallen 4.1 percent below the peak attained at the end of 1973, by far the largest postwar cyclical decline on record. Since then, real disposable income has rebounded sharply, though only half the real loss has been recouped.

In retrospect, the decline in real disposable income over the last two years appears to have been distributed unevenly among workers. Much of the decline can be attributed to the effects of the recession on employment, including the unusually sharp rise in the proportion of part-time to total employment, rather than a drop in the real wages of those full-time workers who have remained employed. Indeed, there has been some confusion over this point. Compounding the confusion is the fact that, according to data collected by the Bureau of Labor Statistics in its payroll survey, average weekly earnings have risen at a slower rate than the consumer price index since 1973 (see Chart II, but note that these are annual observations recorded as of May in each year). In large part, however, the erosion in this measure of the real wage has stemmed from compositional changes within the employed work force. First, while there had long been an uptrend in the proportion of part-time to total employment, the recently ended recession exacerbated this trend greatly, as many formerly full-time workers had to settle for part-time employment along with a sharp cutback in their weekly earnings. Second, for many years including the last few, the full-time work force has been composed of proportionately more women and young workers, both of whom tend to earn less than their adult male counterparts. Adjusted for changes in the age-sex composition, it turns out that the average weekly earnings of full-time workers, after accounting for the effect of inflation, fell only 4 percent between 1973 and 1975 (see Chart II). This was about half of the decline experienced by average weekly earnings in real terms, as measured by the establishment survey. It should be mentioned, however, that these estimates of weekly earnings are measured on a before-tax basis and, therefore, do not take into account the effect of inflation on workers' aftertax earnings. That is, even if consumer prices and before-tax wages do grow at the same rate, the progressivity of the personal income tax structure implies that workers will still experience a reduction in their real aftertax earnings. To some extent, of course, the legislated decreases in the 1975 personal income tax rates have partly offset this effect.

Spurred by the continuation of the recent gains in disposable income, real consumption spending advanced at a 7 percent annual rate in the third quarter, a shade higher than that of the preceding quarter. Consumption outlays have been the dominant factor in the current economic recovery. Since the opening quarter of the year, the expansion in real consumption expenditures has accounted for over two thirds of the total increment in real GNP. Even more importantly, the pickup in consumption has facilitated the liquidation of the huge overhang of inventories.

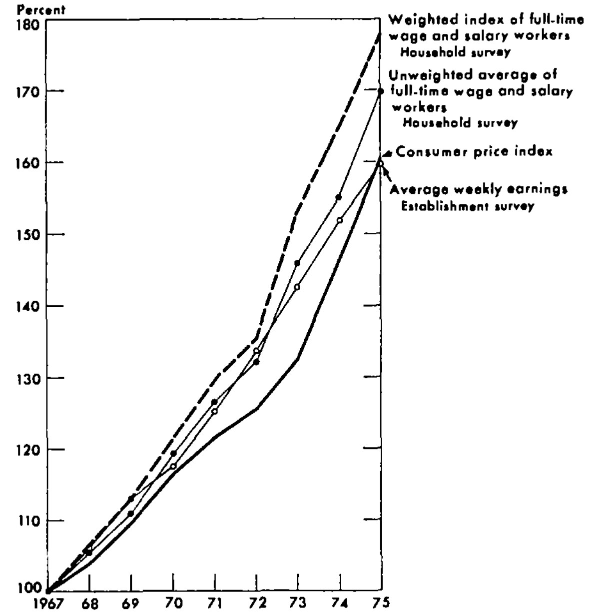
Consumer outlays on durables advanced briskly in the third quarter. Historically, no doubt because these purchases are postponable and often involve replacements, real consumption spending on durables has tended to move in a pronounced procyclical fashion (see Chart III). In recessions, the largest cutbacks in consumption spending occur in purchases of durable goods. In turn, during the ensuing recoveries, real durables outlays snap back vigorously. Indeed, in the four previous cyclical recoveries, the expansion in real consumption durables sales has averaged a bit more than 20 percent in the four quarters after the cyclical trough. The official date of the trough of the most recent recession has not yet been posted by the National Bureau of Economic Research, but it will probably be located in the second quarter since that is when industrial production bottomed out. Hence, given this tentative dating, the current resurgence in real consumer durables spending has to date surpassed those experienced in all previous postwar upturns, except for the 1970-71 recovery which was bolstered by the aftermath of the General Motors strike during the last quarter of 1970. Whether this rapid pace will be sustained in the months to come remains to be seen. Indeed, although the average level of domestic automobile sales in the third quarter was well above that of the preceding three months, the monthly sales pattern has been fairly flat from July to October.

In real terms, residential construction outlays posted a healthy advance in the third quarter, following a minuscule rise in the previous quarter and the precipitous two-year slide before that. The third-quarter increase in real residential construction outlays reflected a higher level of housing starts, compared with the level of the previous quarter.

Chart II

ALTERNATIVE MEASURES OF GROSS WEEKLY EARNINGS

1967 = 100



Notes: Data are for May of each year shown and are not seasonally adjusted. The 1968 data points for the two household series are interpolations of the preceding and following years. The weighted index measure uses fixed 1967 relative employment weights for the earnings of different age-sex groups.

Sources: United States Department of Labor, Bureau of Labor Statistics. The weighted index was calculated by the staff of the Federal Reserve Bank of New York.

Housing starts were running at a 1.25 million unit annual rate in the July-September period, up from the 1 million unit rate averaged in the first half of the year. However, housing starts in September, the most recent month for which data are available, were essentially unchanged from the July level. In the third quarter, mortgage interest rates, which had been at very high levels by historical standards, edged up further. The average yield on Federal National Mortgage Association home-mortgage commitments rose about 80 basis points from the end of June to the end of September, although it declined about 20 basis points in October. While the high rates currently prevailing on home mortgages make them an attractive investment from the viewpoint of thrift institutions, they do tend to discourage potential home buyers from undertaking such long-range commitments. In addition to high mortgage costs, prospective homeowners may be concerned about the rapid run-up in the prices of fuels and utilities.

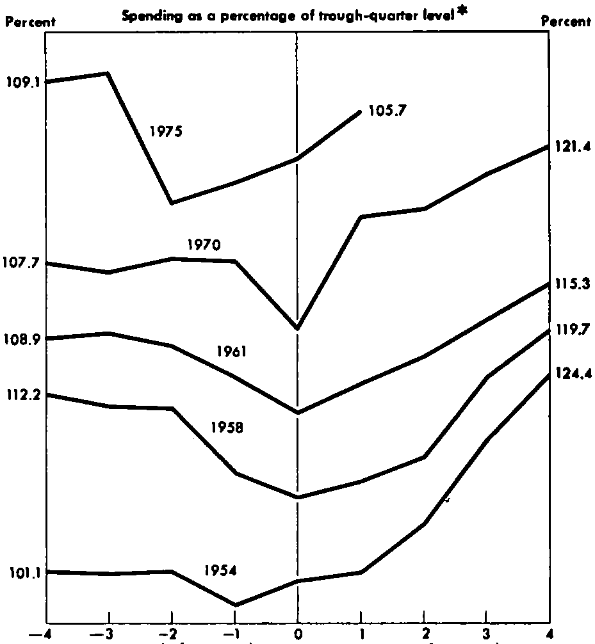
In the third quarter, business fixed investment spending was virtually unchanged in real terms from what it had been in the April-June period. This leveling off marks the end of a steep year-long contraction in real outlays on plant and equipment, which left these expenditures about 17 percent below what they had been a year previously. It is interesting to note that, in past cyclical recoveries, a turnabout in real outlays on plant and equipment has occurred either in the same quarter or one quarter after the business-cycle trough.

It remains to be seen, however, whether the pattern of real capital spending in the current recovery will turn out to be consistent with historical experience. To some extent, businesses may lately have boosted their capital spending in response to the temporary increase in the investment tax credit. This increase is due to lapse at the end of the year. Even if extended, however, the higher investment tax credit is not likely to exert much additional stimulus to capital spending, unless business conditions continue to improve in other respects. Indeed, capital spending within the key manufacturing sector remains weak, judging by the recent behavior of net new capital appropriations by the nation's 1,000 largest manufacturers. On a seasonally adjusted basis, net new appropriations have declined steadily from the peak of $15.9 billion recorded in the third quarter of 1974 to $8.8 billion in the second quarter of this year, the latest period for which data are available. In view of the significant lags separating appropriations, orders, and actual expenditures, the recent drop in net new appropriations has probably not yet had its full depressive effect on manufacturers' actual outlays on plant and equipment. Nevertheless, there seems to be a rather large backlog of unspent

Chart III

REAL CONSUMER DURABLES SPENDING IN FIVE POSTWAR RECESSIONS

Spending as a percentage of trough-quarter level*



*For each reference cycle the trough-quarter level equals 100 percent.

Note: The National Bureau of Economic Research-dated recession troughs occur in second quarter 1954, second quarter 1958, first quarter 1961, and fourth quarter 1970. The trough quarter for the latest recession has not yet been dated by the NBER. Industrial production bottomed out in the second quarter, which is used as the trough quarter in the chart.

Source: United States Department of Commerce.

appropriations, suggesting that firms have lately been postponing projects rather than canceling them. Hence, if there were a pickup in the pace of real final sales, this would be an incentive for businesses to decide to go ahead with their postponed projects. The rundown in the backlog of unspent appropriations would impart added momentum to investment spending but probably not before the end of the year.

Net exports declined in the third quarter in both nominal and real terms, as imports of goods and services posted a larger advance than exports. Modest increases in this spending component in three previous quarters had acted as a stabilizing influence, albeit a minor one, just as it has in most postwar recessions.

PRICE SITUATION

Although erratic monthly movements in the recent price data have made their interpretation difficult, it nevertheless appears that the overall annual rate of inflation in the third quarter was about 7 percent. As measured by the GNP implicit deflator, prices of goods and services advanced at a 5 percent annual rate. However, the fixed-weight GNP price index, which is unaffected by compositional shifts in output, rose at a 7.2 percent seasonally adjusted annual rate, compared with 5.5 percent in the second quarter. In the previous postwar recoveries, price increases generally continued to moderate in the period immediately following the trough in industrial production. Hence, at this early point in the recovery, a significant acceleration in inflation would be an unusual and unlikely occurrence. Yet any further slowdown in the rate of inflation will be severely constrained by the underlying pressure from wages and materials costs.

Consumer prices rose at an 8.2 percent seasonally adjusted annual rate in the third quarter, up from the 5.8 percent advance in the previous quarter. Food prices increased at an 11.8 percent annual rate, mostly because of the large spurt in July. Similarly, nonfood commodity prices climbed at a 7.2 percent annual rate, also reflecting a July spurt and much more moderate advances in the last two months of the quarter. Prices of services exhibited modest gains through the months of the third quarter except in September when the large gain posted was primarily the result of the subway fare increase in New York City. Thus, while the third quarter's rate of price inflation was higher than the previous quarter, price gains tended to be moderate in the last two months of the quarter. In part, the midsummer flare-up in nonfood prices may have reflected an unsustainable slowing of price increases in the last months of the second quarter as firms were attempting to get out from under the very substantial inventory overhang.

At the wholesale level, there was a resurgence in inflation in October, following the very moderate advance in the previous month. The October run-up in wholesale industrial prices amounted to a rapid 14.4 percent annual rate and was paced by large price increases for milled steel products, new passenger cars, textiles and apparels, and lumber and wood products. Including the October spurt, wholesale industrial prices have steadily accelerated over the past six months. While this pattern probably in part reflects the unsustainably low price increases recorded in the second quarter, when so many firms were doggedly trying to get out from under the massive overhang of inventories, the prolonged upward thrust in the rate of inflation in wholesale prices is a rather worrisome development. Also, the wholesale prices of farm products and of processed foods and feeds posted a rather big increase in October, moving ahead at about a 20 percent annual rate.

WAGES, PRODUCTIVITY, AND EMPLOYMENT

Recent data indicate that the pace of wage increases quickened somewhat in the third quarter. Compensation per hour worked in the private nonfarm economy rose at an 8.5 percent seasonally adjusted annual rate, up 1 percentage point from the rate of growth over the first half of this year but below the quarterly increases posted in 1974. Output per hour worked, which typically exhibits the largest advances in the early part of the recovery period, moved ahead at a 9.4 percent seasonally adjusted annual rate. As a result of these changes, unit labor costs edged downward at a 0.8 percent annual rate in the third quarter.

According to data gathered by the Labor Department on major collective bargaining settlements, the average effective wage of approximately 10 million unionized workers has risen at a 9.6 percent annual rate over the first nine months of the year, about the same as the 9.4 percent increase recorded in 1974. The average effective wage adjustment reflects first-year increases negotiated in the current quarter, deferred increases under earlier contracts, and cost-of-living raises accumulating under current and previous contracts. There was a sharp run-up in the effective wage rate in the third quarter, due to a substantial increase in cost-of-living adjustments as well as to larger deferred increases. For the entire private nonfarm economy, average hourly earnings—which are conceptually similar to the effective wage adjustments in the unionized sector—advanced at a seasonally adjusted annual rate of 7.1 percent, above the rate of increase in the first two quarters of the year. A better indicator of the level of wage rates in the private nonfarm economy, however, is the adjusted average hourly earnings series, since it abstracts from fluctuations in average hourly earnings which are attributable to interindustry shifts in employment and variations in overtime hours in manufacturing. In terms of quarterly averages, the adjusted average hourly earnings series posted a seasonally adjusted annual rate of growth of 8.3 percent in the July-September period, up slightly from the 7.8 percent increase during the first half of the year but below the 9 percent rise in 1974.

Nonfarm employment posted increases in both the household and payroll surveys in the month of October. However, a substantial increase in the labor force combined with a large reduction in agricultural employment resulted in a 0.3 percentage point increase in the civilian unemployment rate. According to the payroll survey of establishments, seasonally adjusted payroll employment increased by 217,000 workers in October, marking the fourth consecutive month of healthy payroll gains. As in previous months, manufacturing payrolls played an important role in the rise, accounting for about half of the October increase. The remainder of the rise was distributed between the services and government sectors. In the separate survey of households, nonagricultural employment moved ahead by 147,000 workers. However, agricultural employment fell by 124,000 workers in the month so that civilian employment was little changed on balance. At the same time, the labor force posted a substantial gain of 252,000 workers, and the seasonally adjusted civilian unemployment rate rose by 0.3 percentage point to 8.6 percent of the civilian labor force.