The Business Situation

Economic activity is continuing to expand, but the upward impetus is narrowly based and has slackened somewhat in recent months. In October, there was a discernible slowdown in the pace of the recovery from that recorded for the third quarter.* While industrial production rose for the sixth consecutive month, the October advance was less than half as large as the average of the earlier months and was also not so broadly diffused. Similarly, there was an appreciable slowing in the growth of nonagricultural employment in November. Yet, because of a large drop in the civilian labor force in that month, the unemployment rate declined to 8.3 percent, the same level that had prevailed in September.

The latest readings of the other monthly business statistics also point to a temporary lull in the economic recovery. Retail sales have been relatively sluggish since July, following several months of very large increases. Consumption spending may be buoyed in months to come, however, by continued advances in personal income. Single-family housing starts have recovered substantially during the past six months, but construction of apartment buildings remains slow. Capital spending has also remained weak. There are increasing signs that inventory liquidation is drawing to a close. Businesses have clearly gone a long way toward paring their excess inventories and have succeeded in establishing a much better balance between sales and inventories.

Despite the occasional monthly flare-ups, the inflation rate appears still to be hovering around the 7 to 8 percent range. While this is unusually rapid by historical standards, it still represents a major improvement over the prolonged double-digit increases recorded last year. Consumer prices, led by a fairly stiff increase in retail food prices, accelerated a bit in October. Excluding food, however, the October rise in consumer prices was actually below the average for the previous six months. Wholesale prices were unchanged in November, as the large drop in agricultural prices offset the moderate advance in the prices of industrial commodities. Looking ahead, there appears to be little reason to anticipate a fresh burst in the rate of inflation in the coming months. There has, in fact, been some easing in the rate of increase in nonfood consumer commodity prices in recent months, and retail food price increases are currently expected to slow considerably as the record 1975 crops come to market. Also, the large gains in productivity typically associated with the early phases of economic recovery may help to blunt some of the inflationary pressures arising from the sizable increases in wages. Moreover, the substantial slack in the labor market is likely to exert a restraining influence on wage increases for some time to come, particularly in less organized sectors of the economy. However, there are major questions surrounding the large number of major collective bargaining agreements scheduled for 1976.

INVENTORIES AND INDUSTRIAL PRODUCTION

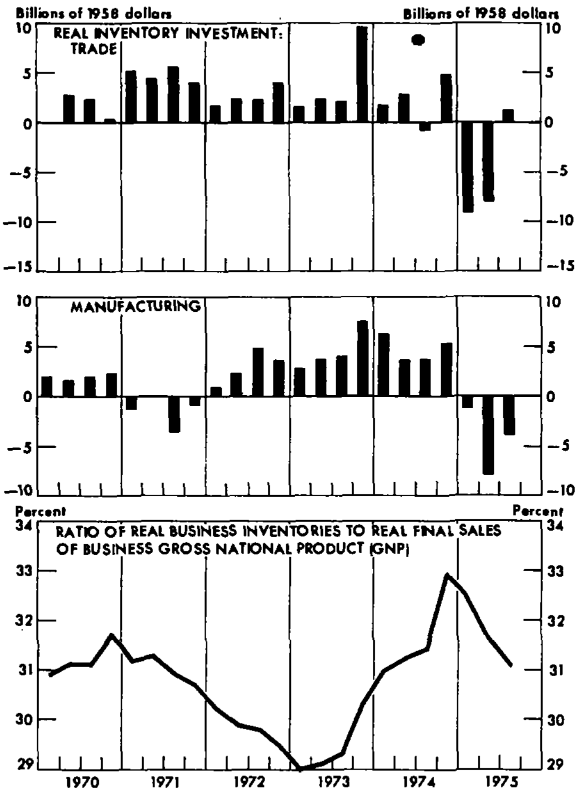
It appears that most of the once massive inventory overhang has largely been eliminated, and some businesses have begun to replenish their depleted stockpiles. Measured on a GNP basis, the real inventory-sales ratio for the business sector declined further in the third quarter to the lowest level since the opening quarter of 1974 (see Chart I). This level, it may be noted, is in line with past experience at similar stages of cyclical recoveries. At the same time, the rate of inventory liquidation was much reduced from what it had been earlier in the year. Within the trade sector, while wholesalers were still reducing their real inventory stocks during the third quarter, retailers had actually begun to add to theirs. However, the book value data suggest that a turnabout in inventory investment may have occurred in the wholesale trade

* According to revised estimates, the increase in real gross national product (GNP) amounted to a 13.2 percent annual rate in the third quarter, up 2 percentage points from the preliminary estimate. The rate of inventory liquidation was revised downward, while the advance in real final sales was revised upward. The rate of growth of the implicit price deflator for GNP was also adjusted downward slightly to a 4.7 percent annual rate. Released along with the GNP revisions were preliminary estimates of corporate profits in the third quarter. Pretax corporate profits, expressed at an annual rate and adjusted for changes in inventory valuation, increased an estimated $17.6 billion to $122.5 billion.

Chart I

REAL INVENTORY INVESTMENT AND REAL INVENTORY-SALES RATIOS IN THE GNP ACCOUNTS

Seasonally adjusted annual rates



Source: United States Department of Commerce.

sector as well at the end of the third quarter. Within the manufacturing sector, the liquidation of real inventories continued in the third quarter but at about half of the pace of the preceding quarter. In October, nondurables manufacturers posted their third consecutive monthly gain in the book value of inventories. The book value of durables manufacturers' inventories, however, registered another decline. This drop more than offset the gain for nondurables manufacturers, but the net decline for the total manufacturing sector was the smallest this year.

The Federal Reserve Board's index of industrial production posted a moderate 0.4 percent gain in October. While this marked the sixth consecutive monthly rise, the October advance was less than half as large as the average of the earlier months and was also not so broadly distributed. Consumer goods output continued to climb in that month, but the output of capital goods and defense equipment slipped back after previous advances. Symptomatic of the more sluggish growth in the production pipeline, the increase in output of materials in October was less than one fourth as large as the average gain for the previous four months. Iron and steel have once again resumed the declining pattern evidenced throughout most of 1975 and interrupted only briefly in August when there was a bunching of purchases by steel mill customers, an effort apparently aimed at stocking up before the announced price increase took effect on October 1. If output were to continue to grow at the markedly slower October pace, it would take quite a while before production recovered the ground lost during the recently ended recession. As of October, industrial production was still 8.6 percent below the November 1973 peak. Furthermore, the Wharton index of capacity utilization for the industrial sector stood at 80.3 percent in the third quarter, 16 percentage points below the peak recorded two years earlier.

PERSONAL INCOME, CONSUMER SPENDING, AND RESIDENTIAL CONSTRUCTION

Personal income posted another solid gain in October, amounting to $12.7 billion at a seasonally adjusted annual rate. Wage and salary disbursements rose by $8.7 billion, and this marked the eighth consecutive month of growth. About $2 billion of the October increase in wages and salaries was attributable to a pay raise for Federal Government employees. The rest of the increase in wage and salary disbursements was widespread across payroll categories.

After fairly rapid growth earlier in the year, consumption spending has been flat in recent months. Retail sales in October were only slightly above the level of July, and this sluggish pattern for the monthly sales figures has characterized both durables and nondurables sales categories. Domestic automobile sales also exhibited little buoyancy over the July-November period. To be sure, the succession of sizable monthly advances in personal income continues to provide the wherewithal for further gains in coming months. Perhaps, though, consumers' lingering uncertainties about employment prospects and inflation may be tempering the strength of the recovery in consumer spending. For example, while the index of consumer sentiment, as measured by the Survey Research Center at the University of Michigan, rebounded in the second quarter from the all-time low recorded in the first quarter, it showed little further progress in the third quarter and remained at a low level by historical standards.

Thus, the relatively flatter pattern for retail sales since midsummer may be an indication that consumers have taken cautious wait-and-see attitudes at this early point in the recovery.

Residential construction appears to be showing some tentative signs of improvement. To date, the recovery in housing starts compares rather favorably with the upswings in past housing cycles, although the current recovery has proceeded from a very depressed level. In October, housing starts were running at a 1.46 million unit annual rate, up slightly more than 200,000 units from the third-quarter rate. Almost all of the increase was in single-family starts. Building permits, which had risen about 10 percent in September to their highest level since June 1974, were essentially unchanged. Yet, despite the rebound in housing starts, a number of factors suggest that the rate of recovery in housing in the near term will be more sluggish. Although the overhang of unsold new single-family homes has been reduced considerably, the backlog nevertheless remains high. Even more importantly, mortgage terms have remained tight despite large savings inflows. Lenders seem hesitant to issue new mortgages, perhaps because of fears of rising interest rates and induced outflows. At the same time, demand remains weak as buyers face large uncertainties over the economic outlook and high home prices, and the run-up in energy costs probably continues to discourage prospective buyers.

NEW ORDERS, CAPITAL SPENDING, AND LEADING INDICATORS

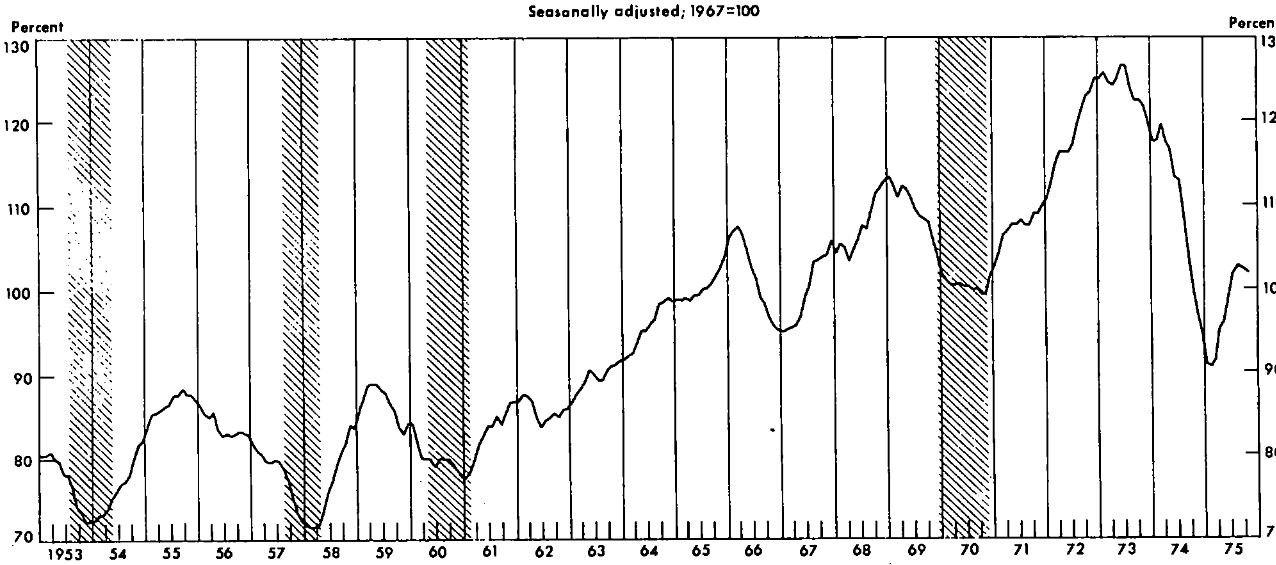
After dropping in the previous month, the flow of new orders received by durable goods manufacturers advanced in October. Actually, the October gain would have been bigger but for a fairly large decline in the bookings for defense goods, a development unrelated to the current state of business conditions. Excluding new defense bookings, the increase in new durables orders amounted to $0.9 billion in October, which more than erased the dip of the preceding month and which was a bit above the average monthly gain recorded over the March-August period. As shipments of durable manufactured goods also rose in October and exceeded new orders, the backlog of unfilled orders edged down further, continuing the pattern of the past year. In contrast, at this stage of the recovery during previous postwar upturns, the backlog of unfilled durables orders had usually begun to rise.

While real business capital spending leveled off in the

Chart II

COMPOSITE INDEX OF LEADING INDICATORS

Seasonally adjusted; 1967=100



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.

third quarter following four quarters of declines, there are no signs of any exuberance in this sector, where recovery typically lags behind that in other sectors. The recent McGraw-Hill survey of planned capital outlays points to a 9 percent rise for 1976 with an equal increase in capital goods prices, thus implying no gain in real spending levels. A similar projection was obtained by the Commerce Department in its October-November survey of planned plant and equipment spending; it was reported that businesses expect to step up their capital outlays in the first half of 1976 at a 10.6 percent annual rate, compared with what they were planning to spend during the second half of 1975. While the various surveys have generally tended to underestimate capital outlays in the first years of recoveries, the lackluster outlook evidenced by the surveys is corroborated by recent monthly data on new orders for nondefense capital goods. Although new orders rose in October, the most recent month for which data are available, they were slightly below their July level.

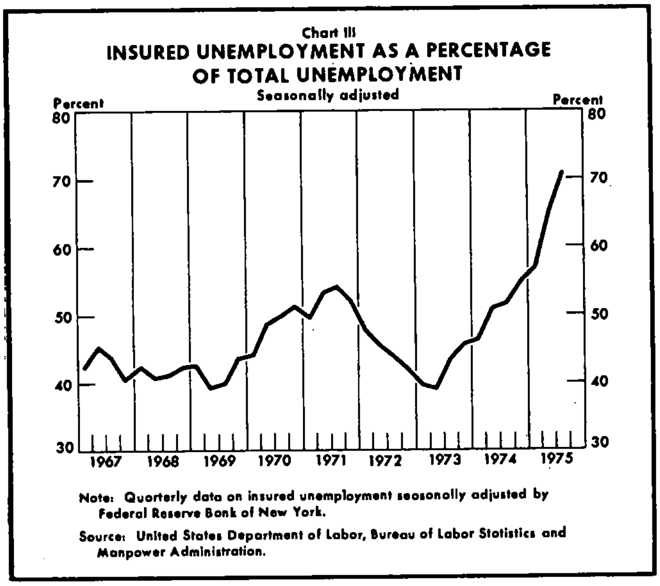
An interesting barometer of economic activity is the composite index of leading indicators, which is assembled and published each month by the United States Department of Commerce. The index is made up of a dozen individual data series and is designed to provide an advance reading on the direction of economic activity. Several of the data series, such as net business formation, building permits, new orders for consumer goods and materials, and contracts and orders for plant and equipment, represent early indications of spending intentions. After a while, these decisions show up as actual expenditures. Other data series, such as the average workweek, the layoff rates, changes in the wholesale prices of crude materials, and vendor performance, reflect the decision of managements in reaction to the perceived strength of prospective demand. Also included in this index, but harder to characterize, are common stock prices, the real money stock, and changes in total liquid assets.

The revised composite index of leading indicators has fallen in each of the past two months from 102.6 in August to 102.0 in October (see Chart II). The question arises whether this drop points to a downturn in economic activity or to a slowdown in the rate of growth. An examination of past episodes where the index declined in two successive months after increasing in previous months reveals that the most recent two-month decline is the smallest in the postwar period. The two components that declined for two straight months and accounted for most of the drop in the index were the real money supply and liquid assets. However, it appears that the real money supply expanded strongly in November following contractions in the two previous months. In addition, the rebound of the composite index of leading indicators prior to the declines in the past two months had been quite strong, compared with the upturn pattern in past early recoveries. It should be noted that, as a recession predictor, the composite leading indicators series has exhibited a number of false signals. For example, downturns in 1962, 1963, and 1968 were not followed by major downturns in economic activity. However, the sluggish pattern of the index in the past two months is consistent with the pattern of slower growth exhibited by a number of other monthly series and may be an indicator that the pace of the recovery in the near term will remain considerably below the extremely rapid third-quarter rate.

LABOR MARKET DEVELOPMENTS

The slackening pace of the economic recovery has carried over to the labor market. In November, nonfarm employment was essentially unchanged in both the household and payroll surveys. According to the payroll survey of establishments, seasonally adjusted payroll employment edged up by a scant 41,000 workers following four months of very hefty gains. Indeed, from June to October, the increment in payroll employment amounted to more than 1.2 million workers. In the separate survey of households, nonagricultural employment dipped by 33,000 workers and agricultural employment fell by 130,000 workers subsequent to a similar decline in the previous month. However, the civilian labor force, which often exhibits volatile movements on a monthly basis, fell by a substantial 464,000 workers. Because of the proportionately greater decline in the labor force, the seasonally adjusted civilian unemployment rate fell 0.3 percentage point to 8.3 percent of the labor force, bringing it back to its September level.

While the average number of unemployed workers has been substantially higher in 1975 than in the previous year, there has also occurred a sharp increase in the proportion of unemployed workers who are eligible for unemployment insurance benefits (see Chart III). For those who are eligible, these benefits act partially to replace the income lost due to unemployment. By acting as a cushion for lost wage and salary income, unemployment insurance benefits also tend to stabilize aggregate consumer outlays on goods and services. These benefits are a particularly potent stabilizer since they are not subject to the personal income tax or social security payments. Typically, the fraction of unemployed workers eligible for benefits rises during recessions. This partly reflects the greater numbers of adult men and job losers among the ranks of the unemployed; these groups have larger fractions who qualify



to receive unemployment insurance benefits. In the most recent recession, new legislation which temporarily extended the benefit period has also had an impact in raising the proportion of unemployed workers who receive benefits. This proportion has in fact risen throughout 1975 to 70.9 percent in the third quarter, by comparison with a figure of 51 percent for all of 1974.

Although the tempo of wage rate increases appears to have picked up in the two most recent months, the monthly wage data typically exhibit considerable variability, and the overall rate of wage inflation seems to be about in line with that registered in the third quarter. In the July-September interval, average hourly earnings in the private nonfarm economy, adjusted for interindustry shifts and overtime in manufacturing, advanced at an 8.4 percent seasonally adjusted annual rate. This was identical to the gain in the first quarter of this year but slightly above the second-quarter rate of advance. The advances in adjusted average hourly earnings in October and November brought the three-month growth in the adjusted index to a seasonally adjusted annual rate of 8 percent.

PRICES

Although there have been a number of flare-ups in both wholesale and retail prices in recent months, it appears that the typical pattern of moderating price increases in early recovery phases is continuing in the current recovery. The twelve-month growth rate in the consumer price index, which smooths out much of the monthly volatility of retail prices, has fallen steadily over 1975. In October, the twelve-month growth rate in consumer prices stood at 7.6 percent, down substantially from a figure of almost 12 percent with which the year began. This slowdown reflects continuing moderation in recent months in consumer nonfood commodity prices and services prices (apart from higher New York City subway fares in September). In addition, there is the encouraging prospect that food price increases are likely to slow considerably as the record 1975 crop comes to market.

On a seasonally adjusted basis, the wholesale price index in November was virtually unchanged from the level of the previous month. This development reflected a substantial drop in the index for farm products and processed foods and feeds, combined with a moderate increase in wholesale prices of industrial commodities. Wholesale prices of farm products and processed foods and feeds fell at a seasonally adjusted rate of 1.2 percent (not annualized) following very rapid gains in the previous two months. While these prices have been advancing fairly rapidly in the past six months, as of November they actually stood slightly below the level of a year ago. Prices of industrial commodities rose at a 0.6 percent seasonally adjusted rate in November, marking the first month since April that the rate of increase in these prices did not accelerate further. It should be pointed out, however, that prices of nonagricultural intermediate materials and supplies, which are an important input for nonfood commodities at the retail level, have advanced at a 7.5 percent seasonally adjusted annual rate over the past three months. In November, these prices stood 5.2 percent above the year-ago level.

Consumer prices climbed at a 0.7 percent seasonally adjusted rate in October, a somewhat faster rate of increase than the moderate gains of the two previous months. All the acceleration, however, was attributable to the run-up in the volatile food prices component. According to the Department of Agriculture, however, the growth of retail food prices should moderate to a 4-5 percent annual-rate range in the first half of 1976. Consumer prices of nonfood commodities, which had risen at an average annual rate of about 7 percent in the first three quarters of the year, have averaged about a 5 percent annual rate over the three most recent months. Increases in the prices of services have remained moderate in recent months, apart from the September spurt which largely reflected higher subway fares in New York City.