The Business Situation

The pace of the economic recovery apparently picked up toward the year-end, following a marked slowdown in the fall. In December, there were sizable gains reported in nonagricultural employment, the average workweek, and overtime hours. To be sure, the unemployment rate held steady at 8.3 percent, but this reflected an outsized December increase in the civilian labor force. At the same time, retail sales surged ahead on a wide front, including an advance in domestic car sales. Retail sales had exhibited only modest increases between July and November, while automotive sales were virtually flat. In coming months, continued growth in consumption spending seems likely now that a compromise has been reached on tax legislation between President Ford and the Congress. Under this agreement, the 1975 tax cuts will be extended to the end of June of this year, and the Congress issued a promise to consider limits on Federal Government spending in fiscal 1977.

In the price area, a major source of near-term uncertainty was also cleared up when the President signed the Energy Policy and Conservation Act into law on December 22. The new legislation establishes an upper limit on the average price of domestically produced oil which is more than $1 per barrel lower than the average price prevailing at the end of 1975. It also provides for some rather modest increases in domestic oil prices over the longer term. At the same time, the Administration has removed the $2 per barrel duty on imported oil. The near-term impact of these actions will probably be a reduction in crude oil prices; in the absence of the new legislation, there would have been a major inflationary shock as a result of immediate decontrol.

The recent price news has been reasonably favorable on balance. In December, wholesale farm and food prices fell substantially for the second consecutive month; industrial wholesale prices continued to rise more rapidly than earlier in the year but sharply below 1974 rates of advance. In November, retail prices of commodities other than food continued their recent, quite moderate performance. Retail food prices, however, while rising less than in October, still showed a somewhat disappointingly rapid advance. Looking ahead, the current projections of the Department of Agriculture indicate a relatively modest 4 to 5 percent annual rate of increase in retail food prices in the first half of 1976, less than half the rise recorded in the second half of 1975. Of course, these estimates are subject to substantial change because of weather conditions and other unforeseen developments.

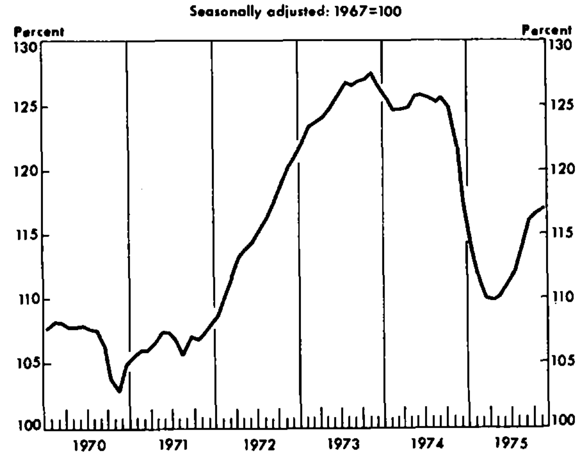
CONSUMER SPENDING AND RESIDENTIAL CONSTRUCTION

After a brief respite in the fall, consumption spending has lately shown renewed signs of vigor. Indeed, seasonally adjusted retail sales spurted 3.5 percent in December, the sharpest monthly advance since July 1973. By comparison, from July to November the rate of growth in consumption spending had amounted to a sluggish 1.4 percent, virtually all of which was attributable to higher retail prices. The December surge in retail sales was paced by the huge 11.3 percent increase in the automotive sector. Sales of domestic automobiles in December totaled 8.2 million units at a seasonally adjusted annual rate, up 7.9 percent from the preceding month and the highest rate since August 1974. Sizable gains were also recorded in December in sales of both department stores and furniture and home-furnishings stores.

Consumers can now look forward to a continuation of the 1975 tax cut, at least for a while, as a result of the recent compromise worked out between the Congress and the President. Under the compromise, President Ford agreed to extend the tax cut through June 30, 1976. In return, the Congress promised that, should it continue the tax cut beyond this date, it would consider reducing expenditures by an equal amount. Had this agreement not been reached, consumers' tax liability for the first half of 1976 would have jumped by approximately $7 billion. Also scheduled for this year is another increase in social security taxes under legislation that was passed at the end of 1973. In 1975 social security taxes were collected on only the first $14,100 of wages and salaries, but in 1976 these taxes will be collected on the first $15,300. The higher ceiling will lower spendable income in 1976 by about $1 billion, most of which will take effect in the second half of the year.

Residential construction seems to be gradually recovering from the battered condition it was in at the end of 1974. In November, housing starts slipped by 82,000 units to a seasonally adjusted annual rate of 1.38 million units, but this was greatly overshadowed by the increase of almost 200,000 units in the previous month. Indeed, despite the November decline, the level of starts in that month remained significantly above the average level for the third quarter. Building permits rose in November, reaching their highest level in eighteen months. While housing starts rose substantially in the third quarter, the increase proceeded from a very low level, and the industry remains in a depressed state. The very high levels of mortgage interest rates currently prevailing may continue to exert a considerably dampening influence on the near-term housing recovery.

Chart I
INDUSTRIAL PRODUCTION
Seasonally adjusted: 1967=100



Source: Board of Governors of the Federal Reserve System.

INDUSTRIAL PRODUCTION AND INVENTORIES

The Federal Reserve Board's index of industrial production posted a modest increase in November. Although production was up for the seventh consecutive month, the November advance amounted to a mere 0.2 percent, only one-fifth as large as the average gain of the previous six months (see Chart I). At this point, the pace of the current recovery is comparable to that of most previous postwar recoveries. However, while industrial production has risen 6.3 percent above the trough of April 1975, it still remains 8.4 percent below the November 1973 peak. Thus, if production were to continue to expand at the average rate of the past seven months, it would take an additional nine months before the previous peak would again be attained. Output of consumer durables, which has been a bulwark of the recovery, continued to climb in November despite a drop in the output of automobiles. At the same time, production of consumer nondurables was marginally higher. The output of business equipment rose slightly in November following a decline in the previous month. While equipment production has edged up from its July trough, it currently remains well below the peak levels of late 1974. The output of materials rose in November for the sixth consecutive month but by the smallest amount in this period.

The inventory adjustment process appears to be now largely completed, and some businesses have even begun to rebuild their inventory stocks, albeit at a fairly cautious pace. In the retail trade sector, wherein the inventory liquidation had commenced at the beginning of 1975, physical stocks actually rose in the third quarter. Moreover, in October, the most recent month for which data are available, book value accumulation was about double the average gain in the three previous months. In fact, the ratio of retailers' book value inventories to retail sales has risen three months in a row. While there are conceptual problems in interpreting book value data (and book value to sales ratios) in inflationary periods, the most recent figures suggest a pickup in inventory investment in the retail sector. In the wholesale trade sector, the aggregate book value of inventories has risen in the past three months following declines in all but one of the previous seven months. Book value inventories for manufacturing inched up for the second month in a row in November after seven months of decline. Although inventories in the durable goods sector continued to slide, there seems to be an easing in the rate of liquidation. The November drop was the smallest in seven months and was more than offset by the buildup in nondurable goods manufacturing.

NEW ORDERS AND CAPITAL SPENDING

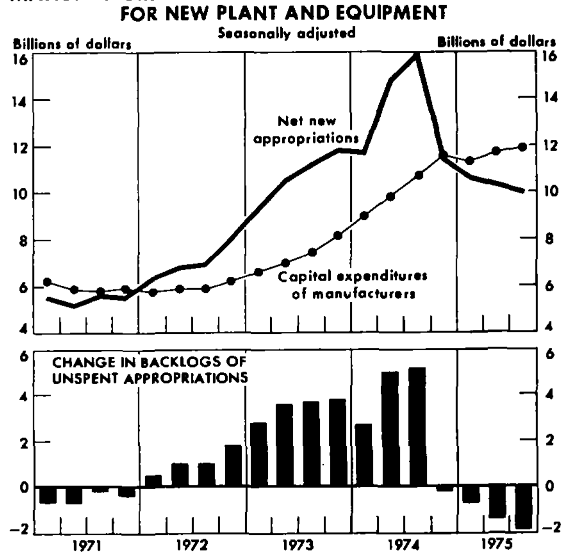
The flow of new orders received by durable goods manufacturers declined in November, after rising in the previous month. To a large extent, this seesaw pattern has reflected the monthly movements in export orders for nonautomotive durable goods. Excluding new defense bookings, durable goods orders fell $1.4 billion in November, which was more than enough to offset the $1 billion increase in the preceding month. Looking at the record of the current recovery, total durables orders bottomed out last March, spurted $6.7 billion from then until August, and declined $1.4 billion from then until November. This pattern is not at all unusual inasmuch as similar ones occurred in the 1955, 1961, and 1971 recoveries. Since shipments in November exceeded new orders, the backlog of unfilled orders edged downward, further continuing the pattern evidenced throughout most of 1975.

Capital spending remains weak, and there are no signs of any exuberance in this sector. According to a recent survey conducted by The Conference Board, net new appropriations for new plant and equipment by the nation's 1,000 largest manufacturers continued to fall in the third quarter, although the decline was the smallest of four consecutive drops beginning in the fourth quarter of 1974 (see Chart II). Actual capital outlays by large manufacturers were up slightly and exceeded net new appropriations, so that the backlog of unspent appropriations declined for the fourth consecutive quarter. Despite these declines, the backlog remains at a relatively high level, suggesting that many projects might have been postponed rather than canceled. For the economy as a whole, real capital spending leveled off in the third quarter, and the October-November Department of Commerce survey points to at least some real growth in capital spending over the first two quarters of the year. On the other hand, a more recent Commerce Department survey indicates a modest decline in real spending for the year as a whole, a development which would be highly unusual at this stage in the recovery.

Chart II

MANUFACTURERS' EXPENDITURES AND APPROPRIATIONS FOR NEW PLANT AND EQUIPMENT

Seasonally adjusted



Source: The Conference Board, Inc.

LABOR MARKET

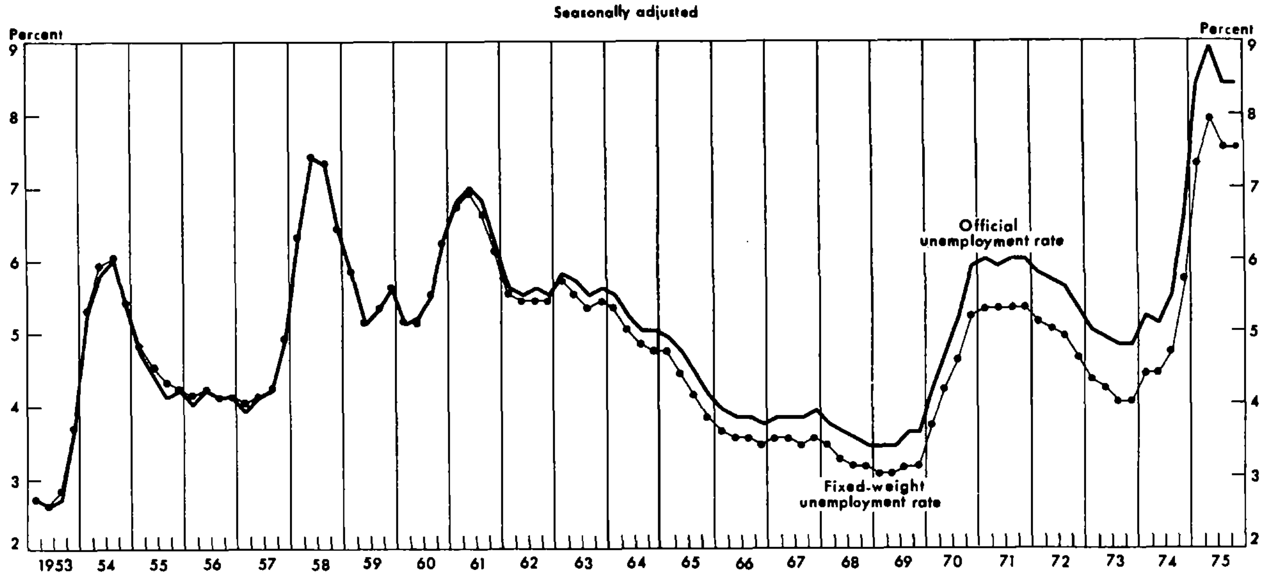
Labor market conditions strengthened appreciably in December, thus ending the year on a positive note. According to the establishments survey, about 240,000 workers were added to the payrolls of businesses in the private nonfarm sector in December. This advance was fairly widely based, and was about one-third larger than the average monthly increment recorded in earlier months of the recovery. Besides hiring more workers, businesses also extended working hours. The average workweek for the private nonfarm economy lengthened in December for the third consecutive month. Within the key manufacturing sector, the average workweek increased 0.4 hour to 40.3 hours, an unusually large monthly advance. In the separate survey of households, the gain in employment amounted to about 230,000 workers, following the slight decline of the previous month. Nevertheless, because of the proportionately equal increase in the civilian labor force, the overall unemployment rate held steady at 8.3 percent. Since peaking at 9.2 percent in May, the unemployment rate has varied between 8.3 percent and 8.6 percent in subsequent months. For the year as a whole, the unemployment rate averaged 8.5 percent, up 2.9 percentage points from the previous year.

Although unemployment certainly remains high by historical standards, the overall unemployment rate appears to overstate to some extent the current degree of labor market slack, compared with earlier years in the postwar period. Over the past two decades, women and teen-agers have constituted an increasing proportion of the labor force. These workers change jobs more frequently than adult males do and also tend to enter and leave the labor force more often. Because an unemployed person is defined as one who is jobless but is looking for work, the relatively frequent spells of looking for new jobs result in higher unemployment rates for women and teen-agers. As the labor force share of these groups rises, so too does the overall unemployment rate. Chart III compares the official unemployment rate with a fixed-weight measure which weights the unemployment rates of the major age-sex

Chart III

A COMPARISON OF OFFICIAL AND FIXED-WEIGHT RATES OF UNEMPLOYMENT

Seasonally adjusted



Note: The fixed-weight unemployment rate was calculated by the staff of the Federal Reserve Bank of New York, using as relative weights the 1956 age-sex composition of the labor force.

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

groups by their relative importance in the labor force in 1956. This latter measure provides a comparison over time, which abstracts from those changes in the overall unemployment rate that arise from relative shifts in the labor force. Based on the age-sex composition of the labor force in 1956, the peak unemployment rate in 1975 was not very much higher than the maximum rates in 1958 and 1961. At the same time, the jobless rate for men aged twenty-five and older has been about equal to the peak rate in 1961 but below the 1958 rate. At least in some respects then, the current degree of labor market slack is roughly comparable to the 1958 and 1961 experiences.

PRICES

The latest readings on inflation are moderately encouraging on balance. At the wholesale level, prices declined 0.6 percent in December. This decline entirely reflected the large drop in the prices of farm products and of processed foods and feeds. At the same time, the rate of growth of industrial wholesale prices stood at 0.6 percent. This was essentially unchanged from the November advance but remained below the increases recorded in the preceding three months. Among industrial commodities, the largest price increases were posted for lumber and wood products, pulp, paper, and allied products, and cigarettes. The growth in prices of fuel and power continued to be moderate after their sharp midyear flare-up.

Consumer prices rose at a 0.7 percent seasonally adjusted rate in November, a rate of gain about the same as the October advance but somewhat faster than the two previous months. Prices of consumer services rose 1.1 percent in the month, reflecting higher prices for automobile insurance, telephone service, parking, and hospital care as well as higher mortgage interest rates and property taxes. While the pervasiveness of these increases is somewhat disturbing, services prices had been rising at more moderate rates in recent months—apart from the September spurt which largely reflected the New York City subway fare increase. Nonfood commodity prices continued the very modest pattern of increases exhibited in recent months. The November monthly increase of 0.3 percent brought the three-month growth rate of these prices to a seasonally adjusted annual rate of 3.7 percent. Food price increases moderated to a 0.6 percent seasonally adjusted rate after increasing more rapidly in the previous month. According to the Department of Agriculture, retail food price gains are expected to slow to a 4 to 5 percent annual-rate range in the first half of 1976. This would be about half as fast as the rate of growth recorded for the second half of 1975, compared with the first six months of the year.

In December, the Congress passed the new Energy Policy and Conservation Act, and the measure was signed into law at the end of the month. Many of the provisions of the new law will have a direct bearing on the cost of crude oil to domestic refiners. First, the bill imposes a ceiling on the average price of domestically produced crude oil of $7.66 per barrel, which is more than $1 below the average price prevailing at the end of last year. Under the Emergency Petroleum Allocation Act, there had been a price ceiling of $5.25 per barrel on domestically produced "old" oil—i.e., oil produced from domestic wells but not exceeding the 1972 rate of output from these wells. If President Ford retains this ceiling, then the ceiling price for "new" oil would have to be set at about $11 per barrel. Second, subsequent to the initial rollback, the legislation provides for modest increases in the average price of domestically produced oil. The new law allows the President to raise the ceiling on domestic crude oil prices by at most 10 percent per year until February 1977. From then on, the President can propose increases in the ceiling of up to 10 percent per year, but the Congress has the power to limit the hikes to the overall rate of inflation. Third, to prevent domestic oil producers from taking advantage of the currently higher world price of oil, the new legislation directs the President to establish export restrictions on oil. At the same time the President signed the legislation, he also removed the $2 per barrel duty on imported oil. In the very near term, it is clearly this latter action that will have the dominant impact on the price and quantity of imported crude oil. The physical volume of imported crude oil is likely to rise, and the cost to refiners should fall but perhaps by an amount less than the $2 per barrel import fee. Thus, the immediate impact on the new energy bill will be a reduction in the average price of oil as a result of both the imposition of a ceiling price on new domestic oil and the removal of the import duty on imported oil. Over the longer haul, however, the supply of domestic oil might be reduced in response to additional domestic controls. For one thing, domestic oil suppliers might well expect higher oil prices at some future point when controls would be ended. In this case, there might be some implicit capital gain earned by merely "sitting" on the oil. Hence, domestic oil refiners would have to import additional oil from abroad, and the attendant increase in the effective price of crude oil would no doubt be passed on to consumers.