The Business Situation

The economy has expanded briskly in the past few months, following a temporary slowdown in the recovery last fall.[1] In January, industrial production again posted a strong and broadly based advance. Solid gains were also recorded at the beginning of the year in new durables orders and personal income, while the composite index of leading indicators registered its sharpest increase since July of last year. Retail sales had spurted in December, and most of this gain held up in January as well. The fact that consumption spending did not retreat to pre-Christmas levels, as some analysts had expected, indicates the underlying strength in this key sector. Labor market conditions have also improved greatly in the past few months. Employment expanded further in February, while the unemployment rate dropped 0.2 percentage point to a fourteen-month low of 7.6 percent.

While the general economy continues to recover, some sectors remain depressed. Most notably, residential construction has yet to show signs of a sustained resurgence, and real business fixed investment also continues to be weak. In time, however, the momentum of the economic recovery should help to revitalize activity in these sectors as well.

Meanwhile, the price situation appears to have taken a turn for the better in recent months. The prices of consumer nonfood commodities rose in January at the slowest rate in over two years, and food prices actually declined. As a result, the rate of advance in the consumer price index slowed to a modest 5 percent annual rate. A marked improvement was also evident at the wholesale level. Agricultural prices dropped in February for the fourth consecutive month, while wholesale industrial prices posted their smallest increase since last spring. Overall, wholesale prices fell in February by the largest amount in a year.

[1] According to revised estimates, the advance in real gross national product (GNP) amounted to a 4.9 percent annual rate in the fourth quarter, down 0.5 percentage point from the preliminary estimate. In addition, the level of the implicit price deflator for GNP was revised upward by 0.3 percentage point to 6.8 percent.

INDUSTRIAL PRODUCTION AND INVENTORIES

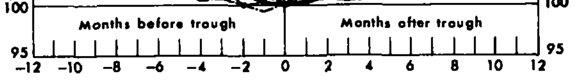
Economic activity continued its upward thrust in January. According to the Federal Reserve Board's index of industrial production, output rose 0.7 percent in that month, marking the ninth consecutive monthly advance. Since bottoming out last April, production has climbed 8.6 percent. Thus far, the progress of the current recovery is quite in line with the rates of expansion experienced in previous postwar recoveries (see Chart I). Nonetheless, because of the severity of the most recent recession, production must still increase an additional 6.9 percent before the November 1973 peak is reattained. Even then, however, output will still fall considerably short of an expanded potential productive capacity.

The January gain in industrial production was broadly based. Across market groupings, output increased for durable and nondurable consumer goods, business equipment, intermediate products, and materials. The gain was also widely distributed among the major industry groupings—durable goods manufacturing, nondurable goods manufacturing, mining, and utilities. Within durable goods manufacturing, output of motor vehicles and parts did decline, but this was the result of cutbacks in the production of automobiles, as the automotive industry sought to bring inventories into balance. Domestic car production slowed from a 7.8 million unit annual rate in December to a 7.6 million rate in January. At the same time, sales of domestic units climbed from an 8.2 million rate to an 8.4 million rate. As a result, car dealers' inventories, which had been as high as 102 days' supply in November 1974, dwindled to a modest 56 days' supply (see Chart II).

For some time now, the rebound in industrial production has received almost no stimulus from the automotive sector. Indeed, automobile production in January was virtually identical to what it had been last July. Now, however, excess inventories of automobiles have largely been eliminated. While there still exists a surplus of small cars, which are not selling as well as had been anticipated, there is a shortage of certain large cars, necessitating some plants to work overtime. At the same time, the sales outlook has improved while the import share of the market has declined sharply. Last spring, 22 percent of all cars sold were imported; in January, the proportion amounted to 12.5 percent. These conditions all point to a pickup in domestic automobile production. Indeed, the first signs of this were visible in February, when automobile production jumped to an 8.1 million unit rate.

In the months ahead, industrial production should get a further boost now that excess inventories in other industries have also mostly been eliminated. Overall, business inventories declined in December for the second consecutive month, as inventories in the retail trade sector were once again pared. In terms of constant dollars, the business inventory-sales ratio fell in the final quarter of 1975 to its lowest value in two years. Whereas earlier inventory reductions had been deliberately engineered, the most recent rundown appears to have been largely unintended. Retailers, who in previous months had been adding to their stocks, were apparently caught off guard by exceptionally strong Christmas sales, and to meet these sales they were forced to deplete their inventory stocks. The wholesale trade and nondurables manufacturing sectors can also be expected to participate in an inventory buildup. Indeed, inventories in these sectors actually rose in December. Only in durable goods manufacturing, which experienced its tenth consecutive monthly decline, does it appear that inventories may still be greater than desired. Yet, even in this sector, the December reduction amounted to the smallest since April, suggesting that durables manufacturers will soon begin to build up their inventories. Thus, for the economy as a whole, the near-term outlook is for inventory accumulation, but businessmen, hurt by excess inventories in the past year or so, are likely to exercise restraint in replenishing their stocks.

Chart I
INDUSTRIAL PRODUCTION IN FIVE ECONOMIC RECESSIONS AND RECOVERIES
Production as a percentage of trough level



Note: The National Bureau of Economic Research has determined that the first four troughs occurred in the following months: May 1954, April 1958, February 1961, and November 1970. The trough for the latest recession has not yet been dated. Industrial production bottomed out in April, which is used as the trough month in the chart.

Source: Board of Governors of the Federal Reserve System.

NEW ORDERS AND CAPITAL SPENDING

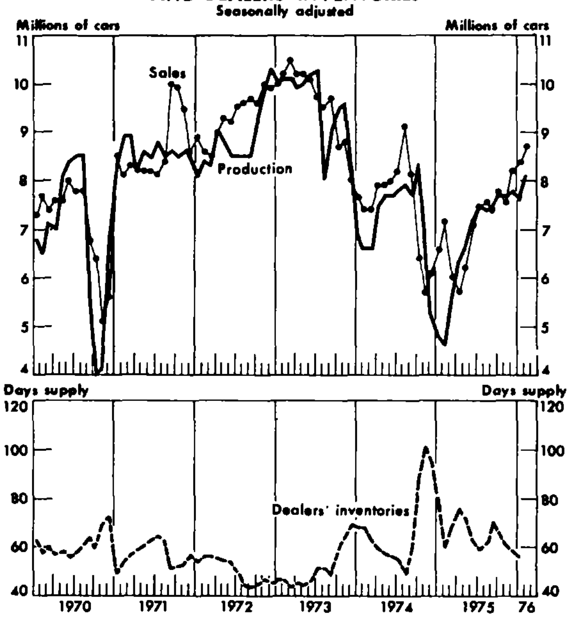
After being essentially flat for four months, the flow of new orders received by durable goods manufacturers increased 3 percent in December, according to upwardly revised data, and advanced another 2.2 percent in January. Because this series is a leading indicator of future economic activity, its lack of exuberance last fall had caused some concern that the recovery might have prematurely stalled. Hence, the recent upturn is especially heartening in that it has helped to dispel such fears. The advance in new orders, however, has not been uniformly distributed across sectors. In particular, new orders for nondefense capital goods have remained sluggish, dropping sharply in December before edging up in January. Durables shipments exceeded orders in January for the fifth straight month, and the backlog of unfilled orders continued to slide.

The lackluster performance of new orders for nondefense capital goods no doubt reflects the lingering weakness in capital spending. Although real business fixed investment did turn positive in the fourth quarter, following six consecutive quarterly declines, recent surveys on planned capital expenditures point to a decline in real investment in the coming months. These predictions may, however, be unduly pessimistic. As sales continue to increase, businessmen may revise upward their plans for investment, especially now that the profit picture has improved. Moreover, prospective capital outlays have traditionally been underestimated in the surveys at this stage of the business cycle.

CONSUMER SPENDING, PERSONAL INCOME, AND RESIDENTIAL CONSTRUCTION

According to advance data, retail sales in January edged down slightly following the December surge. Nevertheless, the fact that retail spending held up as well as it

Chart II
PRODUCTION AND SALES OF DOMESTIC AUTOMOBILES AND DEALERS' INVENTORIES
Seasonally adjusted



Source: Board of Governors of the Federal Reserve System.

did in January was widely regarded as a sign of underlying strength. Although monthly movements have been quite erratic, the trend in retail sales is clearly upward. Indeed, over the past four months, sales have advanced at an annual rate of about 12 percent. January's decline was more than accounted for by lower sales in the automotive sector. Despite an increase in unit sales of domestic automobiles, initial reports indicate that total sales in the automotive sector—which includes, among other things, purchases of used cars as well as imported cars—fell sharply below December's level. Excluding the automotive component, sales actually advanced 0.6 percent.

The outlook for future increases in consumption spending remains bright, as personal income is continuing to rise. In January, personal income climbed at a 13.6 percent annual rate, the sixth consecutive monthly advance. Over this six-month period, personal income has grown, on average, at an 11.6 percent annual rate. The bulk of the January gain came from higher wage and salary disbursements, as increased man-hours were translated into increased payrolls. The continued sharp rise in income may soon be matched by an increased willingness to spend. As consumers gain confidence that the economy is recovering, they are likely to cut back on their savings, now at a historically high rate. There are already signs of a renewed willingness to buy on credit. Consumer instalment credit rose in January by the largest amount in seventeen months.

The residential sector is one area where spending has remained weak. Although this sector is in much better shape than a year ago, it has yet to show signs of a sustained healthy resurgence. Indeed, in January, for the third consecutive month housing starts slipped. Even here, however, there are reasons for optimism. Early this year, the Administration agreed to release $3 billion in Federal funds for the purpose of lowering mortgage interest rates on certain multiple-family housing to 7.5 percent. This should stimulate the multifamily sector, which has been the most depressed. Single-family housing should also benefit from lower mortgage rates which have fallen considerably below last fall's lofty peaks. Another encouraging sign is the dwindling backlog of new housing. January's inventory-sales ratio for new one-family homes was the lowest in three years. Finally, building permits jumped 10.7 percent in January to reach a twenty-month high.

LABOR MARKET

Conditions in the labor market strengthened further in February. The number of workers on nonagricultural payrolls showed a healthy gain of 210,000, as most major industries continued to add to their payrolls. Average hours of work did slip—both in manufacturing and in the private nonfarm economy—but still remained at or above their 1975 highs.

According to a separate survey of households, nonagricultural employment expanded by almost 300,000 workers, while total civilian employment increased slightly, following an outsized gain in the previous month. At the same time, the size of the civilian labor force was virtually unchanged. Hence, the unemployment rate fell 0.2 percentage point to 7.6 percent in February, the fourth straight month of declining joblessness. February's drop in the unemployment rate was particularly reassuring. Because of possible seasonal adjustment problems, many analysts thought that the decline registered in the previous month might have been overstated, with some predicting an upturn or at least a leveling-off in February. The fact that the jobless rate continued to fall, however, suggests that recent data showing improvements in the labor market have primarily reflected underlying market conditions rather than misestimation of seasonal factors. With the strengthening of the economy, civilian employment now has returned to its pre-recession peak while the unemployment rate, although still high by historical standards, is at its lowest level in fourteen months.

PRICES

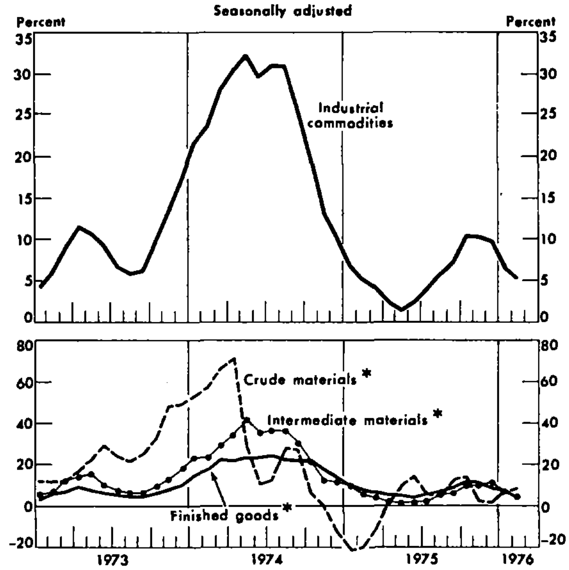
Wholesale prices declined in February, marking the fourth consecutive month that these prices have either fallen or held steady. The drop, 0.5 percent (not annualized), was the largest of the past year. Price increases for industrial commodities continued to decelerate (see Chart III). February's 0.3 percent advance was only half as fast as the average rate of the previous six months. One of the most encouraging signs was the turnaround in the prices of crude materials. Between November and January, these prices had advanced at an average of 1.6 percent per month. Moreover, the National Association of Purchasing Management revealed that in recent months a growing percentage of its members have faced rising materials prices. Because price increases tend to work through by stage of process, there had been some concern that wholesale prices of finished products might accelerate in the near future. But, with wholesale prices of crude materials declining 1.2 percent in February, that now appears at least somewhat less likely. Wholesale food prices also declined in February. Thanks to 1975 record harvests, the prices of farm products and processed foods and feeds have now fallen 7.6 percent since October.

Chart III

INDUSTRIAL WHOLESALE PRICES BY STAGE OF FABRICATION

Change from 3 months earlier at annual rate

Seasonally adjusted



* Excludes foods and feeds.

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

The effect of lower food prices at the wholesale level was manifested to consumers in January. After rising 0.6 percent in both November and December, the food component of the consumer price index declined in January by 0.2 percent. Because wholesale food prices typically lead retail prices by several months, the near-term outlook for consumers' grocery bills is bright. The Department of Agriculture predicts that food price increases will be limited to 1 percent in each of the first two quarters of 1976. What will happen after that, however, is especially uncertain, since it will depend in large part on weather conditions. Of particular concern are the winter drought and dust storms of the grain belt, which have caused the Department of Agriculture to lower its estimates of harvest yields.

The overall consumer price index advanced at a 5 percent annual rate in January, 1.5 percentage points below the rate of the previous month.[2] Nonfood commodities continued their pattern of moderate inflation and rose at a 2.4 percent rate, abetted by a drop in energy prices. This marked the fifth consecutive month in which prices of nonfood goods have increased at less than a 5 percent rate. On the other hand, services prices accelerated in January to a rate almost double that of the preceding month. Part of the run-up was attributable to a one-shot boost in postal rates. Another portion, more worrisome, reflected higher medical costs and automobile insurance rates, which have both risen fairly rapidly in recent months.

[2] Beginning with the January data, the Bureau of Labor Statistics has revised its procedures for seasonally adjusting the series that make up the consumer price index. Adjusted values of the indexes are now derived by adding together their seasonally adjusted components, whereas before the total consumer price index and its major components had been seasonally adjusted independently of each other.