The Business Situation

The latest business statistics indicate that the economic recovery is continuing at a fairly vigorous pace. During February, retail sales advanced strongly and industrial production moved up at a moderate rate. The increase in economic activity has been reflected in significant gains in employment, and the unemployment rate eased further to 7.5 percent in March. In the last few months, consumer buying has contributed major strength to the recovery. Consumers have stepped up their purchases of big-ticket items, such as automobiles and appliances, putting the economic recovery on a much more solid footing than it was in earlier stages. At the present time, the main weak spot is plant and equipment spending which has failed to show any clear-cut signs of an incipient upturn. Although demand for these investment goods remains weak, the index of leading indicators continues to signal further expansion in the near term.

Inflation has slowed markedly at both the retail and wholesale levels in recent months. Consumer prices rose at a 1.4 percent annual rate in February, the lowest inflation rate in over four years. Wholesale prices were also a source of favorable news, as they increased only slightly in March and remained below December levels. To some extent, however, the recent moderation in inflation has reflected declines in the prices of food and energy items, and it would be overly optimistic to extrapolate the recent experience far into the future. Nevertheless, inflation rates well below the double-digit level appear in prospect.

INDUSTRIAL PRODUCTION AND INVENTORIES

During February, the Federal Reserve Board's index of industrial production registered a 0.5 percent increase, the tenth consecutive monthly advance. The February rise was fairly broadly based across industry and market groupings, an encouraging sign that the economic recovery is now on a solid footing. While industrial production in February stood 9.3 percent above the cyclical trough, it still has a way to go before the ground that was lost in the recession is fully recovered. Even at recent robust rates of advance, industrial production would not reach its November 1973 peak until early 1977. In fact, only in the nondurable consumer goods sector has the prerecession peak in output been exceeded.

The automotive sector contributed substantially to the industrial output rise of February, and the available information suggests that a strong gain also occurred in auto output in March. Auto assemblies were up 200,000 units from the improved February level, reaching an 8.3 million unit seasonally adjusted annual rate in March. In recent months the automotive industry has experienced a dramatic improvement in demand from the depressed level earlier in the recovery. Sales of domestic automobiles, which had been essentially flat from late July to November, have picked up considerably since then. Indeed, in February and March, unit sales of domestic automobiles averaged 8.75 million at an annual rate. This represents a 15 percent advance over November and is the highest sales rate since August 1974. While auto manufacturers have stepped up production by a sizable amount, the increase has not been large enough to match the expansion in sales and auto inventories have declined. According to industry sources, an inventory stock equal to about 60 days' supply is regarded as the minimal reserve for the spring selling season. Inventories have been drawn down well below this level, reaching about 50 days' supply at the end of March. It is, therefore, no surprise that the automobile manufacturers reportedly plan to boost their production in the next few months, especially for the larger car models which are in particularly short supply.

In other industries as well, inventory building is likely to be a source of upward thrust in the near future. By the end of last year, it seemed that most businesses had run down their once excessive inventories to the point where further reduction might have resulted in interruptions in the productive process as well as in delays on deliveries of finished goods. Indeed, some analysts asserted that the declines in November and especially in December were unintended, resulting from unexpectedly strong sales. Recent data suggest that some rebuilding of stocks has begun. The book value of business inventories increased $1.2 billion in January, as gains were recorded in the wholesale trade, retail trade, and manufacturing sectors. Yet, despite the sizable accumulation, the inventory-sales ratio declined further to a level which is low by historical standards. February data for the manufacturing sector indicate that nondurables manufacturing inventories continued to increase, while the change in durables manufacturing inventories turned positive for the first time in a year. The February accumulation was modest, however, and inventory-sales ratios decreased further in both durables and nondurables manufacturing, as shipments continued to advance rapidly. As a result, substantial further inventory accumulation is likely to be necessary to bring stocks to a comfortable level.

NEW ORDERS AND LEADING INDICATORS

Led by a 28.8 percent surge in orders for automotive equipment, new orders received by durable goods manufacturers spurted 7.4 percent over the three months ended in February. Orders for nondefense capital goods exhibited a modest 1.1 percent advance over the same period, however, and new orders for machinery and primary metals have shown only moderate momentum. The lag of new orders in these industries is important because past movements in new bookings have tended to be fairly reliable advance indicators of changes in economic activity.

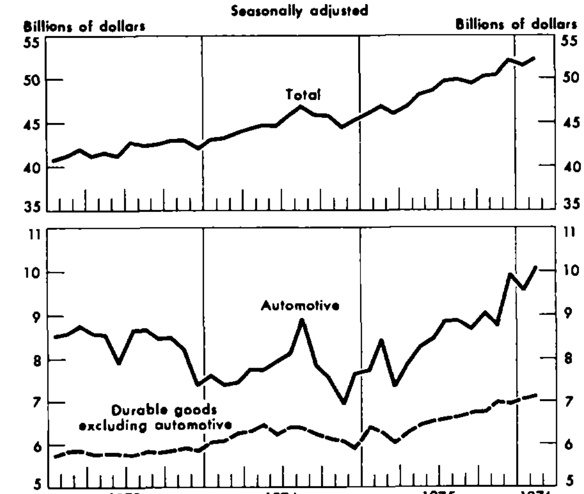
The Commerce Department's composite index of leading indicators has resumed its advance following last fall's sluggish performance, which had caused considerable apprehension. The index has increased 3 percent since November. Eight component series rose, contributing to February's 0.8 percent gain, while three components fell. Though the February increase was well below the revised 1.5 percent January spurt, the recent performance of the leading indicators provides corroborating evidence of a near-term continuation of the recovery.

PERSONAL INCOME AND RETAIL SALES

In February, personal income rose $12.9 billion, a slightly smaller gain than in the preceding month but one well above that averaged in 1975. A part of the February increase was attributable to a speedup in certain veterans' benefits, as well as to the receipt of a Federal earned income tax credit (for calendar 1975) by some low-income households with dependent children. Wage and salary disbursements also continued to climb, although the advance was somewhat smaller than in prior months. Over the last three months, wages and salaries have increased at a robust 11 percent annual rate.

The quickening pace of consumption spending that occurred at the end of last year has carried over into the current year. Retail sales had shown comparatively little growth from July to November but have risen strongly since then (see Chart I). In February, total retail sales increased $0.8 billion and were 4.1 percent above the November level. Though the recent gains have been widespread among the major spending categories—nondurable and durable goods—the rise in spending for durable goods has been most marked. Since November, retail durable sales have advanced 9.3 percent. Looking ahead to coming months, further gains in consumption spending would appear to be in the offing. The unemployment picture has brightened considerably, as has the economic outlook in general. Moreover, the heady advance in the stock market in recent months has substantially restored the wealth positions of many consumers. These favorable developments may facilitate future sizable increases in consumption outlays, particularly for durable goods. Indeed, according to the latest surveys, there has been a sharp rise in consumer confidence, which is usually associated with willingness to spend.

Chart I
RETAIL SALES
Seasonally adjusted



Source: United States Department of Commerce.

RESIDENTIAL CONSTRUCTION AND CAPITAL SPENDING

Residential construction activity reportedly rose sharply in February, as housing starts spurted ahead 27 percent on a seasonally adjusted basis. The previous three months had shown declines. It has been suggested, however, that the huge February increase may have been overstated due to the application of standard seasonal adjustment procedures. February is typically a cold and wintery month in which residential construction is rather low, so that the reported number of starts is blown up to get seasonally adjusted housing starts, an estimate which eliminates the usual impact of weather in February and permits comparison with other months. This February, however, the weather was unusually mild in the colder regions of the country and construction occurred at an unusually high rate for that time of the year. Hence, for this February, the usual seasonal factor for housing starts resulted in too high a level of seasonally adjusted starts, thus accounting for the appearance of a February spurt. To the extent that construction slated for the spring months began early, housing starts in coming months will tend to be somewhat lower than otherwise. Nevertheless, the outlook for residential construction continues to improve. Permits to build new housing units advanced 13.3 percent during the first two months of this year. The recovery in this sector has been dramatic, with permits up about 60 percent from their low point of a year ago.

Demand will probably improve further, as personal income continues to rise and fears of layoff recede. In the Federal National Mortgage Association April 5 auction, both government-underwritten and conventional mortgage rates declined. Conventional mortgage rates fell from their October peak of 10.02 percent to 9.05 percent in April, while government-underwritten mortgage rates dropped 1.01 percent over the same period. These factors may contribute to housing demand during coming months.

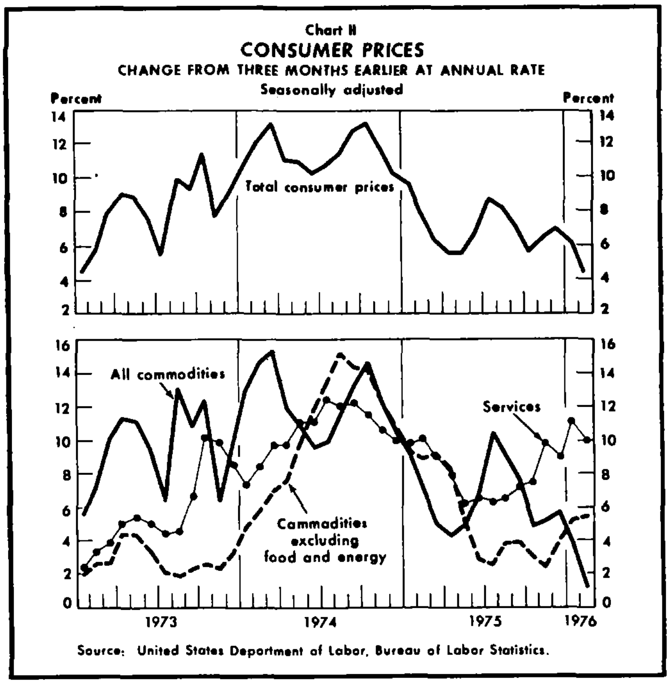
Business fixed investment appears unlikely to contribute much stimulus in the near term. At present, business firms possess substantial excess capacity. Indeed, the current large overhang of excess productive capacity appears to be the principal factor underlying the pessimistic response obtained by the recent Commerce Department survey of planned plant and equipment spending. The latest survey, conducted during January and February, indicates that planned business fixed investment expenditures for 1976 will be 6.5 percent above 1975 levels. Different sectors exhibit a wide divergence in spending plans. The public utilities plan a 15.4 percent increase in plant and equipment spending, while transportation industries (rail, air, etc.) plan sizable cuts in investment expenditures. The scheduled increase in the manufacturing sector is 8.1 percent—stronger than the total—due to the rapid planned advance of capital spending by the nondurables producers. Overall, however, if this survey is accurate, capital spending in real terms is likely to be up only slightly, if at all.

In interpreting the outlook for business capital spending, several other points are worth noting. First, low capital spending is common in the early part of a recovery. Typically, production strengthens because of increasing demand, and then firms decide to expand capacity. Moreover, many firms tend to underpredict the growth of sales during an upturn and therefore underestimate their capacity requirements. Second, the high backlog of unspent appropriations suggests that there could be a very short lead time to capital spending once businesses decide to go ahead with investment. Third, the costs of financing investment are down. Internally generated funds have exhibited a recent surge and, according to the McGraw-Hill survey, pretax business profits are expected to increase an additional 18 percent in 1976. Equity financing opportunities have been enhanced by the recent rise in stock prices. And last year's worries concerning the possibility that Treasury borrowing would crowd out private investment financing seem to have been largely dispelled. Indeed, the interest rate on long-term debt is now slightly lower than at the recession trough.

PRICES

At both the wholesale and retail levels, inflation has moderated in recent months, in large part because of reduction in food and energy prices. Wholesale prices edged up in March following declines in the previous two months. Prices of farm products and processed foods and feeds were down slightly after four months of sizable drops. With retail food profit margins rather high, some further declines in consumer food prices are likely. Wholesale prices of industrial commodities advanced at a 4.7 percent annual rate which brought the average rate of increase in the first quarter of 1976 to 3.6 percent, a marked improvement from the last half of 1975.

Consumer prices rose a modest 0.1 percent in February, the best monthly performance in over four years. Overall, the performance of the consumer price index during recent months has been quite encouraging (see Chart II). A good part of the recent slowdown in prices, however, is attributable to declines in food prices—a volatile component which is usually not indicative of general price trends—and to declines in energy prices,



resulting in part from recent legislation. Excluding these items, the past three months' experience is somewhat less favorable. For example, consumer commodity prices other than food and energy increased at a rate of 5.5 percent per annum during the three months ended in February, and prices for services advanced at a 10 percent annual pace over this interval. While the favorable behavior of wholesale prices probably augurs well for the consumer price index in the near term, over the longer term inflation may well be more of a problem. One concern is the rate of wage increase over the coming year. The calendar of scheduled union contract negotiations is quite heavy for 1976, and the terms in the new contracts will have an important impact on overall labor costs.

LABOR MARKET CONDITIONS

Labor market conditions continued to improve in March. Reflecting the trends in production and sales, nonagricultural employment increased by 191,000, its ninth consecutive month of gain, and the rate of unemployment edged down further to 7.5 percent. The March unemployment drop was quite small, as 264,000 new workers entered the labor force looking for work. The extent and duration of joblessness have fallen dramatically. Since last May, employment gains have far outstripped labor force growth, reducing the number of unemployed workers by 1.2 million. Moreover, in recent months, there has been a sharp drop in the number of persons reporting extended unemployment of more than fifteen weeks' duration. Only 2.4 percent of the labor force had been unemployed for fifteen weeks or longer, according to the March survey, compared with 3.3 percent in December.

Improving employment conditions appear to be drawing previously discouraged persons into the work force. In the third quarter of 1975, the Labor Department estimated that 1.2 million such discouraged workers had decided not to search for jobs, despite desiring work, because they believed no jobs were available; in the first quarter this number averaged 0.9 million. With sales continuing to expand, further employment gains appear certain during coming months. If labor force growth picks up in response to improved employment prospects, however, the unemployment rate may tend to recede more slowly in coming months than it has since May.