The Business Situation

Economic activity in the United States has risen at a brisk pace in recent months. Real gross national product (GNP) advanced at a robust 7.5 percent annual rate in the first quarter, marking the fourth consecutive increase since its low point in early 1975. A major impetus to the economy's first-quarter growth was provided by consumers who bought substantially larger quantities of various goods and services, sharply increasing their purchases of new cars. In addition, a sizable thrust was provided by a turnaround in inventory investment, as businesses began to replenish their stock of inventories. Looking toward the future, many economists expect residential construction activity to pick up further as employment increases and consumer incomes continue to rise. Moreover, it is unlikely that there will again be a sharp deterioration in the net export position, as occurred in the first quarter when the United States upswing outpaced that in other countries. Changes in conditions in the labor market during the first quarter reflected the rapid expansion in the level of production. Compared with the previous quarter, about ¾ million more workers held jobs in the nonfarm sector and the unemployment rate dropped almost a full percentage point. Employment showed further strong gains in April but, due to a large increase in the size of the labor force, the unemployment rate remained at 7.5 percent. Other indicators of labor market conditions such as the average duration of unemployment, however, have continued to improve.

Accompanying the first-quarter rebound in economic activity was an unexpectedly dramatic deceleration in the rate of increase in prices. The GNP implicit deflator, the broadest measure of prices in the economy, rose at the lowest rate in nearly four years. Moreover, the behavior of the wholesale and consumer price indexes confirmed the marked slowing in inflation. Most of the recent decrease in inflation, however, resulted from drops in food and energy prices. Since these declines are not expected to continue, some acceleration in the rate of inflation would seem likely over the near term. Indeed, at the wholesale level, April data show a sizable increase in farm prices. Nevertheless, worries about a possible return to the inflation rates seen in 1974 have largely disappeared. From a somewhat longer term perspective, the rate of wage gain is important for the price outlook. Some of the recent news on wage increases has been mildly encouraging, but most of the major wage contracts scheduled for 1976 have yet to be negotiated.

GNP AND RELATED DEVELOPMENTS

According to preliminary estimates, output of final goods and services in physical terms increased at a rather sharp 7.5 percent annual rate during the first quarter. This solid advance marked the fourth consecutive gain in real output and dispelled remaining doubts about the sustainability of the recovery. The level of economic activity has now regained almost all of the ground lost in the steep recession. However, since both the labor force and capacity have grown in the interim, the potential level of output is well above the current level, leaving room for further sizable increases in production. The first-quarter expansion largely reflected a sharp increase in inventory investment and a sizable advance in consumer purchases of both durable and nondurable goods and services. Although most other components also showed gains (see Chart I), net exports declined.

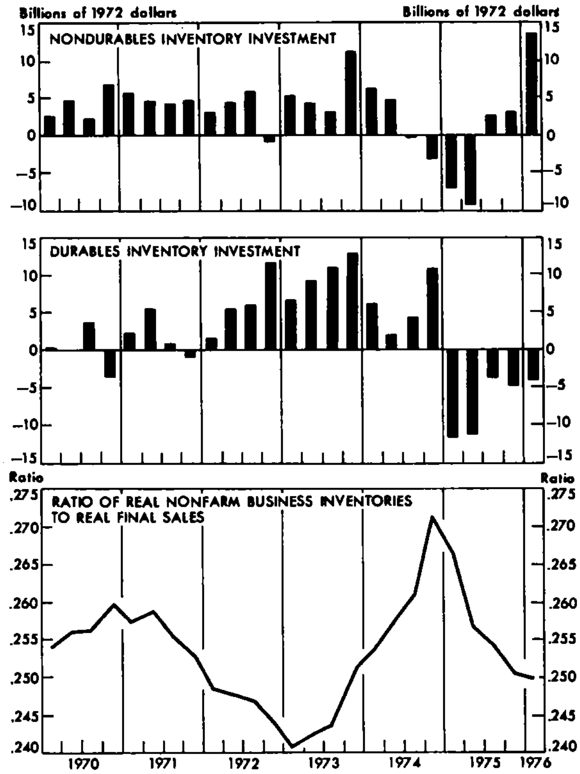
In the first quarter of this year, many business firms began to refurbish their depleted stocks of inventories and the swing from liquidation to accumulation accounted for half of the growth in real GNP. The Commerce Department's preliminary estimates, which are based on incomplete inventory data, indicate that the shift toward accumulation was attributable to businesses which produce nondurable goods (see Chart II). It appears that the excessive inventories held by producers of nondurables in 1974 had been worked off by the end of 1975. In fact, in some industries producing nondurable goods, modest accumulation had begun in the second half of 1975. It is not surprising that the nondurable goods sector, which was the first to begin liquidation of excess stocks, would be the earliest to resume inventory accumulation. In contrast, firms manufacturing durable goods began their inventory reductions somewhat later, and liquidation continued into the early part of the first quarter. The latest monthly data, however, indicate that in February and March durables manufacturers began to build inventories once again. As a result of the massive inventory reduction during 1975 and the pickup in final sales, the overall ratio of inventories to final sales has declined significantly and, by the first quarter of 1976, the ratio of nonfarm business inventories to final sales had fallen close to pre-recession levels. With inventory stocks now at a fairly comfortable level, inventories will have to grow at about the same rate as sales for firms to have large enough stocks of materials, goods in process, and finished goods to operate efficiently.

Consumer spending, which has provided the major stimulus in the upturn, continues to contribute strength to the rebound of production. In the first quarter, consumer purchases of goods and services in real terms advanced at a 7.5 percent annual rate, the largest rate of increase posted since late 1972. Much of the recent surge in consumption has been accounted for by the rebirth of buyers' interest in new cars. Unit sales of domestic models rose to an average of 8.7 million in the January-March period, about 10 percent above the average sales in the final quarter of 1975 and some 22 percent over 1975 as a whole. In April, sales of domestic cars advanced again, reaching a seasonally adjusted 9 million unit annual rate. The resurgence of auto demand has been primarily for standard- and intermediate-size domestic models. The industry, having misjudged the demand mix this year, is apparently near capacity production of these models, and the inventories of autos, which overall are now low relative to sales, are reportedly even lower for these suddenly popular models. Sales of the generally smaller imports, on the other hand, have been very

Chart II

REAL NONFARM INVENTORY INVESTMENT AND REAL INVENTORY-SALES RATIO

Seasonally adjusted annual rates

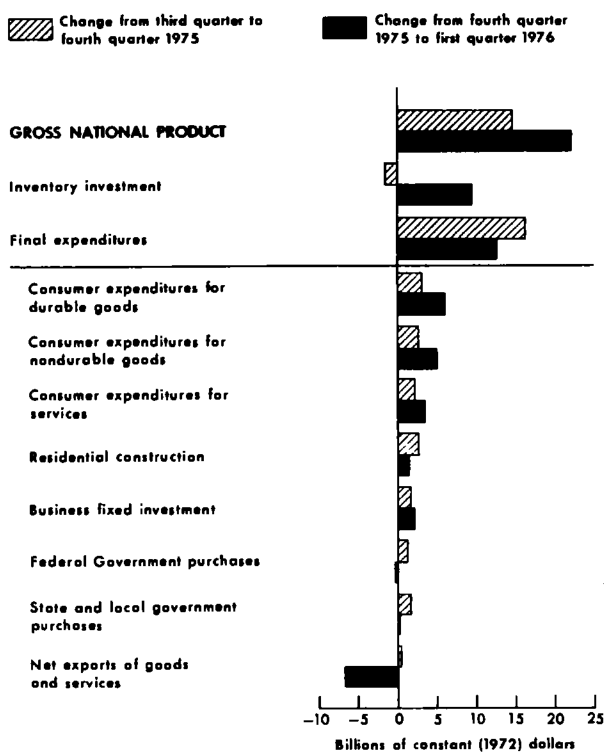


Source: United States Department of Commerce.

Chart I

RECENT CHANGES IN REAL GROSS NATIONAL PRODUCT AND ITS COMPONENTS

Seasonally adjusted



Source: United States Department of Commerce, Bureau of Economic Analysis.

sluggish, holding steady at an annual rate of 1.3 million units, and their share of total United States auto sales has ebbed to about 13 percent, down sharply from the over 20 percent share they had early in 1975. While the resurgence in automobile demand shows every sign of continuing, a production bottleneck could conceivably arise this summer, if the United Rubber Workers' strike against the tire producers becomes prolonged. Automakers say their stocks of rubber-related products could sustain production for only several weeks.

The pickup in sales of autos and other big-ticket items provides tangible evidence of improving consumer confidence. The slowing of inflation, recovery in employment and incomes, and the rebound of equity prices all have fostered a more optimistic outlook and have encouraged spending. The consumer sentiment index of the University of Michigan jumped sharply in the first quarter and now stands close to the level reached before its plunge during the recession-inflation environment of 1974-75.

Undoubtedly, the improvement in consumer sentiment has also played a role in the demand for new houses. Residential construction activity increased at an annual rate of 14.4 percent in the first quarter of 1976. Moreover, since work on new housing units continues for several months and is typically heaviest in the three months after the unit has been started, the recent rate of housing starts and new permits issued suggests that further gains can be expected in the second quarter of this year. Housing starts rebounded sharply in February and remained close to this higher level in March. At 1.44 million units annually, housing starts in March were more than 50 percent above their low point in early 1975. Nevertheless, the industry is operating far below its pre-recession level, with construction of multifamily dwellings particularly depressed. Multifamily housing starts (each apartment is counted as a unit) fell substantially during the first quarter, though several factors suggest that building may strengthen during coming months. Permits for new units, particularly multifamily units, showed gains in the first quarter. In addition, the rate of absorption of new units has picked up recently. Mortgage commitments at savings and loan associations, one of the leading indicators of future building activity, have risen 4.4 percent since the final quarter of 1975, reaching their highest levels since mid-1973. In general, the current and near-term outlook on mortgage money availability is favorable, as savings and loan deposit flows have remained high.

Though business investment in fixed capital remains well below its previous peak, there was a significant increase in real expenditures on business equipment and structures during the first quarter: business fixed investment in real terms grew at a 7.7 percent annual rate. Surveys of planned plant and equipment expenditures carried out earlier in the recovery had indicated that little or no growth in real expenditure could be expected during 1976, but some of these surveys did predict a first-quarter surge. The McGraw-Hill spring survey shows that firms have revised upward spending plans, and other new surveys may show upward revisions as a result of a brighter outlook for demand and improved financial conditions. The early months of 1976 saw rising equity prices, coupled with moderating long-term interest rates, and a resurgence of internally generated funds. With the economy's solid performance reducing many uncertainties about future demand, the likelihood of an advance in capital outlays appears to be improved. Although capacity utilization rates remain relatively low in most industries, firms may begin to undertake modernization expenditures. During the past few years, the types of equipment and structures that business firms find best suited to their needs have been radically altered by the changing relative price of energy as well as by the impact of environmental legislation. It has been argued that firms' responses to these changing conditions were delayed by the recession and that the next few years may find them modernizing their stocks of plant and equipment, thus adding to investment demand.

The sharp deterioration in net exports in the beginning of 1976 reflected a surge in imports at the same time that exports declined. The strong rise in imports was largely attributable to the rapid expansion in economic activity and personal incomes in the United States which increased the demand for all types of goods and services including those produced abroad. In explaining the fall in exports, some analysts point to the fact that the timing of grain shipments to the Soviet Union accounted for some of the declines and that much of the remaining fall was concentrated in the highly volatile civilian aircraft and parts category. Others note that last summer's appreciation of the dollar may have contributed to the decline in exports as well as to the strong rise in imports. Looking to the near future, there are some indications that economic growth of some of the major American trading partners is picking up. This coupled with a more normal rate of expansion in the United States makes it unlikely that further sizable declines in net exports will occur.

Government purchases of goods and services contributed little to the latest rise in aggregate demand. Federal expenditures actually edged down in real terms, as the increase in nondefense expenditures failed to offset the decline in defense spending. The latest information on orders for defense goods indicates that defense spending is likely to be up in the near future so that the level of Federal spending will probably be more stimulatory in coming months. At the state and local levels, spending increases were substantially smaller than in the final quarter of 1975. Apparently reacting to taxpayer resistance to higher levies, state and local payroll employment grew at less than one third of its recent rate. With long-term financing costs high and voter resistance to new bond issues widespread, municipal construction dropped.

As personal incomes are continuing to grow rapidly and the outlook for business expenditures is brightening, there now seems little doubt that the recovery will persist.

PRICES

By virtually every broad measure of price change, inflation has slowed markedly in recent months. As measured by the implicit GNP price deflator, prices of goods and services advanced at a 3.7 percent annual rate in the first quarter, down sharply from the 6.8 percent increase recorded in the previous three-month period and the 8.8 percent rise in 1975 as a whole. The rate of growth of the fixed-weight price index for GNP—which, unlike the GNP deflator, is unaffected by shifts in the composition of output—also showed a sharp deceleration. The fixed-weight deflator rose at an annual rate of 3.9 percent in the initial quarter of 1976, compared with 7.2 percent in the final quarter of 1975.

Consumer prices, as measured by the overall consumer price index, increased at a moderate 4.5 percent pace on a quarterly average basis during the first quarter, compared with a 6.5 percent rate of increase in the fourth quarter of last year. The first-quarter rate of inflation was the lowest recorded since the end of 1972. A closer look at the behavior of the components, however, suggests that temporary factors helped to retard inflation in recent months. During the first quarter, food prices declined for the first time in more than eight years, falling at an annual rate of 2.4 percent. At the same time, consumer energy prices dropped at a 5.4 percent annual rate, reflecting in part the impact of recent legislation. Excluding these items, the behavior of prices has been less favorable. The price of consumer services rose at a 10.5 percent annual pace, while the prices of commodities other than food and energy grew at a 5.4 percent rate. While inflation has cooled significantly from its 1974 rate, the magnitude of price increases for services and commodities other than food and energy during recent months makes it clear that the underlying trend rate of inflation remains above the first-quarter experience. If, as widely expected, the outright declines in food and energy prices are replaced by modest increases, the overall rate of inflation will certainly accelerate in the near term. Such movements will not signal an increase in the trend rate of inflation but rather the absence of large, temporary rates of decline in the prices of food and energy.

In April, wholesale prices of farm products and of processed foods and feeds rose 2.8 percent, thereby recovering half the decline of the past five months. This turnabout caused the overall wholesale price index to rise 0.8 percent despite the sustained decline in power and fuel prices, which fell 0.4 percent. The wholesale prices of industrial commodities continued to advance, climbing a relatively moderate 0.3 percent in April. During the first four months of the year, wholesale industrial prices rose at an annual rate of less than 3½ percent, down substantially from the 9.2 percent rate in the last half of 1975. The surge in prices of farm products and of processed foods and feeds in April suggests that the slide in retail food prices is probably near an end. Wholesale prices of consumer goods other than food, however, edged down in April for the second consecutive month. This development suggests a near-term continuation of relatively modest rates of increase in consumer prices of goods other than food.

WAGES, PRODUCTIVITY, AND EMPLOYMENT

The recent data indicate that there was some moderation in wage pressures in the early months of 1976. The average hourly earnings of private nonfarm production and other nonsupervisory workers, adjusted to exclude the impact of interindustry shifts and of overtime in manufacturing, rose at a 6.2 percent annual rate during the first quarter, the smallest quarterly increase in the last three years. And the first-quarter major collective bargaining settlements indicate a slight reduction in the rate of increase of wages and benefits. The average first-year wage and benefit gain negotiated in the first-quarter settlements covering 5,000 or more workers was 9.5 percent, down from last year's 11.4 percent increase, and the teamster settlement reached in April, which covered 450,000 workers, called for a first-year increase in wages and benefits of slightly over 9 percent. To be sure, a substantial part of the 4.2 million workers whose contracts are slated to expire in 1976 have yet to negotiate new agreements, so that bargains struck in the coming months will be more important for overall wage costs. There are a few signs that these wage increases may be moderate. High unemployment in some sectors has apparently altered several unions' bargaining strategy. For example, in the depressed construction industry, wage increases have been moderate and, indeed, a few unions have even accepted pay cuts in order to be more competitive with nonunion workers. In addition, the United Auto Workers, who are involved in the largest settlement of the year, have announced that job security rather than wage increases will be the primary bargaining issue.

Productivity, as measured by output per hour worked in the private nonfarm economy, increased at a 3.3 percent annual rate in the first quarter of this year after declining in the fourth quarter of 1975. Over the last four quarters, productivity has risen at a rapid 4.9 percent rate. Increased productivity usually occurs at the beginning of an economic upturn, so that the recent pattern was expected. The brisk increase in productivity, coupled with moderate increases in labor compensation per hour worked, has greatly reduced cost pressures. Over the four previous quarters, unit labor costs in the private nonfarm economy rose just 2.4 percent.

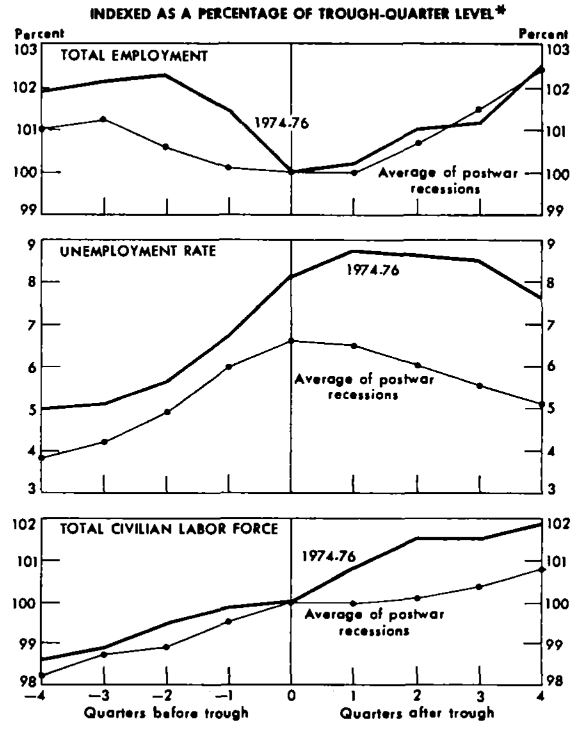
The rapid upturn of economic activity has resulted in a marked increase in employment. Compared with the final quarter of 1975, ¾ million additional workers were employed in the nonfarm sector. Some had been recalled from layoff, and others had found new jobs. This led to a dramatic 0.9 percent fall in the percentage of the labor force who were unemployed. In April, labor market conditions overall continued to improve. Nonfarm payroll employment climbed by 350,000 persons, as most sectors of the economy expanded their work forces. According to the survey of households conducted monthly by the Bureau of Labor Statistics, total civilian employment rose 700,000 in April. A roughly equal spurt in the civilian labor force prevented the strong employment gains from being reflected in the unemployment rate, which remained at 7.5 percent. However, other measures did show further improvement in labor market conditions. For example, the percentage of the labor force unemployed for more than fifteen consecutive weeks fell another 0.2 percentage point, continuing the sharp decline in extended unemployment that began in January.

The conditions in the labor market over the course of the recent downturn and recovery have been somewhat different from the experience in other recessions (see Chart III). Early in the downturn, many firms felt that the decline in economic activity would be mild. They therefore retained a relatively large fraction of their work force and maintained production, allowing inventories to build up. Thus, early in the recession, employment held up well when compared with typical postwar recession experience. Then, as events made it clear that a sales recovery was not going to materialize as quickly as expected, firms found themselves faced with a massive overhang of undesired inventory and they began layoffs, causing employment to drop rapidly. Since its low point in the first quarter of 1975, however, the recovery in employment has been very similar to typical postwar recession experience. In the early part of previous recoveries, however, high unemployment rates induced a falloff in the rate of labor force growth. This phenomenon appears to have been largely absent during the recent cycle. It is not clear why labor force growth has remained so strong. Perhaps the decline in real wages that many nonfarm wage earners experienced led additional family members to seek jobs, or maybe extended unemployment benefits have kept individuals in the labor force who would otherwise have dropped out in discouragement. In any event, the large increase in the size of the work force in this recovery has meant that the unemployment rate has fallen more slowly than it had in past postwar upturns.

Chart III

THE LABOR MARKET IN RECESSION AND RECOVERY

INDEXED AS A PERCENTAGE OF TROUGH-QUARTER LEVEL*



Note: The National Bureau of Economic Research-dated recession troughs occur in fourth quarter 1949, second quarter 1954, second quarter 1958, first quarter 1961, fourth quarter 1970. The trough quarter for the latest recession has not yet been dated by the NBER. The first quarter of 1975 was selected as the tentative trough quarter.

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

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