The Business Situation

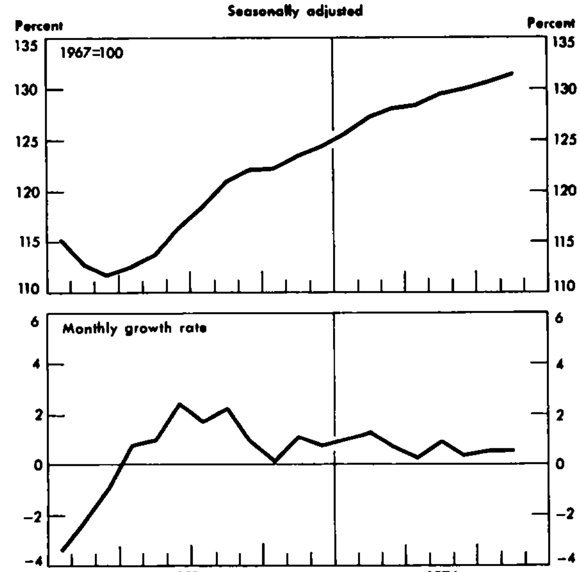
Recent business statistics suggest that the economy is continuing to move up, although it is still too early to tell whether the pattern of slower growth evident since last spring has ended. Consumer spending showed renewed strength in August, as retail sales posted a sharp and broadly based advance. At the same time, housing starts and newly issued building permits increased substantially, providing signs of prospective strengthening in residential construction. Distinctly less encouraging, however, were the August declines in durable goods orders and in the index of leading indicators. Overall, while business activity continues to exhibit upward momentum, the extent of the strengthening, if any, is difficult to assess. Capital spending is likely to play a key role in the months ahead, but the outlook for such expenditures is unclear. On a more positive note, while the nationwide automobile strike has entered into the fourth week, a tentative contract agreement has been reached.

The latest price data have been mixed. At the consumer level, overall price increases have been running at around a 6 percent annual rate for the past several months, but wholesale price increases accelerated in September. Some other developments have been more favorable for the price outlook. Most notable are recent price developments in major metals industries. Steel producers rescinded some previously announced price hikes, and aluminum firms postponed price increases. In addition, spot prices of raw industrial commodities, which are generally regarded as particularly responsive to demand pressures, registered outright declines in September for the second successive month.

INDUSTRIAL PRODUCTION AND CAPACITY

Industrial production rose in August for the seventeenth consecutive month, according to the Federal Reserve Board's index. Preliminary estimates show that output of the nation's mines, utilities, and manufacturing establishments rose 0.5 percent in that month, the same as the increase recorded in July (see Chart I). Following the sharp cyclical expansion in the early months of the recovery, the rate of growth in production has slowed noticeably in recent months. Nevertheless, output in August was about 18 percent above its trough level reached in March 1975. In large measure, some moderation in production gains was to be expected as the recovery matured. In fact, at this point in the recovery, the growth of production is comparable to that in most previous postwar recoveries. Nonetheless, the recent data have been distorted by strikes in the rubber and coal industries, and production in September was affected by the strike of the United Auto Workers' union against the Ford Motor Company, which began on September 15. Recent gains in industrial output have been concentrated largely in durable

Chart I
INDUSTRIAL PRODUCTION
Seasonally adjusted



Source: Board of Governors of the Federal Reserve System.

goods materials, business equipment, and construction supplies. Production of consumer goods has been relatively unchanged in recent months, no doubt reflecting a response to the midsummer lull in consumer buying.

While the continued growth of industrial production has raised the level of output close to its pre-recession mark, concerns over the reemergence of widespread capacity problems appear to have diminished. Virtually all measures of capacity utilization indicate that the economy is operating well below its productive limits. The McGraw-Hill measure of manufacturing utilization stood at 77 percent in August, well below the 88 percent peak recorded in 1973. The Federal Reserve Board's index of capacity utilization in materials-producing industries, which is generally regarded as a sensitive indicator of possible production bottlenecks, also is far below its peak. The level of plant and equipment utilized in the materials-producing sector stood at 81.5 percent in August, some 11.5 percentage points below the peak rate attained in August 1973. Thus, the latest readings suggest that there is ample capacity available to accommodate continued growth of the economy. Moreover, the likelihood of constraints being reached in the near term has been further reduced, of course, by the more moderate rate of growth of real output experienced in the spring and summer.

MANUFACTURERS' ORDERS AND INVENTORIES

Durable goods manufacturers' new orders fell 1.5 percent in August. The decline resulted mainly from a substantial drop in new orders for nondefense capital goods, which, in contrast, had posted an unusually large increase in the previous month. Because month-to-month changes in any economic series can be erratic, such large offsetting movements are not particularly meaningful. Because of concern over the behavior of capital spending thus far in the recovery, however, the decline in capital goods orders has raised, to some extent, renewed anxiety over the outlook for this sector. While there can be little doubt that this sharp decline diminishes somewhat the otherwise generally brightening picture for business fixed investment, its importance should not be exaggerated. Aside from the August drop, nondefense capital goods orders have increased continually this year. Bookings for defense goods recovered in August, after dropping sharply in July. The recent erratic movements in defense orders might be related to the changeover by the Federal Government to a new fiscal year.

Inventories in manufacturing and trade continued to rise, by $1.6 billion in July, with nondurables manufacturing and durables retail trade accounting for most of the increase. The accumulation began in January in response to a strong pickup in sales and continued into the summer, partly as a result of the recent sluggish growth in final sales. Hence, the inventory-sales ratio has rebounded recently, although it has remained well below the level of a year ago. As in July, manufacturers' inventories rose by more than $900 million in August, owing mainly to the buildup in the nondurables sector.

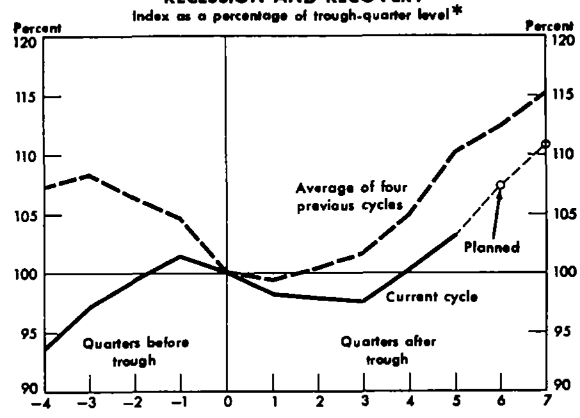
The index of leading indicators fell 1.5 percent in August, with the decline related to the recent sluggishness in consumer spending and some areas of capital investment. Contributing heavily to the drop were the rise in the manufacturing layoff rate, the decrease in contracts and orders for new plant and equipment, and the shortening of the average workweek in manufacturing. While the August decline—the first in eighteen months—may contribute to anxiety over the future course of the economy, a one-month decrease is not sufficient to signal a stalling of the recovery. Historically, the index has turned down, sometimes for several months, even though the economy subsequently continued to expand.

RETAIL SALES AND PERSONAL INCOME

Following several months of lackluster performance, retail sales rebounded strongly in August, rising 2.3 percent on a seasonally adjusted basis. After adjustment for higher prices, this represented an increase of 1.9 percent, pushing sales in constant-dollar terms slightly above the previous peak registered in April. The August sales gain was broadly based, with all major categories of retailers—particularly auto dealers and department stores—posting substantial gains. Some analysts have contended that auto sales would have been even stronger except for shortages of some popular models. It may also be, however, that in efforts to reduce stocks of existing models dealers have offered generous price concessions and consumers have responded by snapping up the available models.

Since last April, retail sales have fluctuated irregularly, with an increase in one month followed by a decrease in the next. The failure of retail sales to break out of this pattern is generally considered a major factor in the overall slowing in the nation's economic advance. A prolonged pickup in sales depends on consumers' willingness to spend as well as on the growth of income and employment. In this regard, the latest surveys of consumers' attitudes suggest no change in their assessment of the economy or in their interest in buying big-ticket items. On the other hand, the prospects for continued gains in personal income appear good. After a strong surge in July due mainly to the midyear cost-of-living increase in social security benefits, personal income posted a more modest increase in August. Part of the slowdown was attributable to the small advance in that month of average hourly earnings in the private nonfarm economy. A decline in farm income, as a result of a sharp drop in wholesale prices of farm products during the month, also was important in moderating the personal income gain. From a longer term perspective, personal income has grown at better than a 9 percent annual rate over the first eight months of the year, well above the experience of earlier recovery periods.

Chart III
PLANT AND EQUIPMENT SPENDING IN RECESSION AND RECOVERY
Index as a percentage of trough-quarter level*



Note: The National Bureau of Economic Research-dated recession troughs occur in second quarter 1954, second quarter 1958, first quarter 1961, and 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.

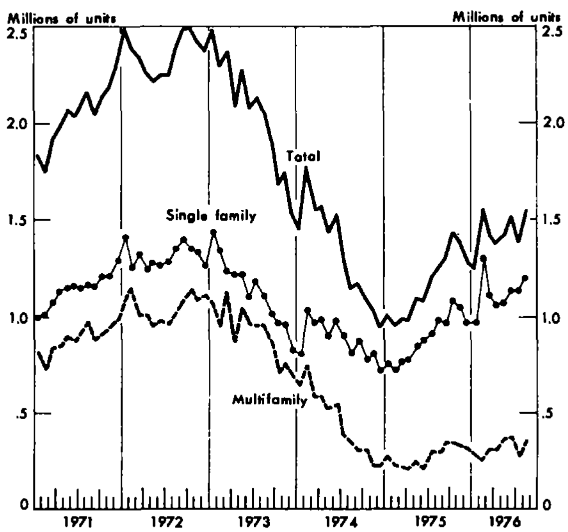
*For each reference cycle, the trough-quarter level equals 100 percent.

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

RESIDENTIAL CONSTRUCTION AND CAPITAL SPENDING

Housing activity showed some encouraging signs in August, with housing starts rising to a seasonally adjusted annual rate of 1.54 million units (see Chart II). This was the highest level of activity since April 1974 and put the level of building activity some 22 percent above a year earlier. Much of the August increase was in the multifamily sector, where starts rose from about 260,000 to nearly 350,000 units. Since one of the major factors restraining the recovery in residential construction activity has been weakness in the multifamily sector, the pickup in starts in this sector was particularly encouraging. Further bolstering near-term prospects was a jump in permits to build apartment complexes of five or more units. Despite this tentative evidence of a pickup in the multifamily sector, the level of activity remains well below that of the peak years of 1972 and 1973. The single-family sector, which has staged a stronger recovery, exhibited renewed strength in August. Single-family starts rose to 1.2 million units, and newly issued permits increased to their highest level since early 1974.

Chart II
HOUSING STARTS
Seasonally adjusted annual rates



Source: United States Department of Commerce, Bureau of the Census.

According to the Commerce Department survey taken in July and August, business spending on plant and equipment is expected to rise 7.4 percent in 1976, little changed from the 7.3 percent increase indicated in the previous Commerce Department survey. However, while the year-over-year growth has changed only slightly, there has been a substantial redistribution of the pattern of spending. As a result, spending in the final quarter of this year is expected to be substantially above that planned earlier. While capital spending typically lags the general recovery, thus far in the current business expansion capital spending has been trailing unusually far behind (see Chart III). Plant and equipment spending currently is only 3 percent above the trough-quarter level. In contrast, at comparable points in previous postwar recoveries, capital spending had typically registered better than a 10 percent gain. Since this comparison is in nominal terms, allowing for the faster rate of inflation in the current recovery would further underscore the recent sluggishness of capital spending. Provided that the revised expenditure plans are realized, the gap between the current experience and earlier recoveries will be reduced. Even more importantly, the prospective revival in capital outlays could go a long way toward quickening the overall pace of activity.

RECENT PRICE DEVELOPMENTS

There has been little indication of a fundamental change in the price situation. Consumer prices rose at a 6.3 percent annual rate in August, only slightly higher than the increase posted over the preceding three months. Retail food prices rose at a 4 percent rate, a somewhat more rapid increase than the very modest advances of the two prior months. With a large harvest in prospect, the outlook for food prices in coming months continues to be favorable, although the weather always adds an important element of uncertainty. Consumer power and fuel prices continued to increase at a rapid rate in August; on the other hand, price increases for consumer services moderated somewhat to a 6.6 percent annual rate.

Fragmentary information about prices of goods at the initial stage of the production process suggests that some further diminution in inflation may be forthcoming. There have been reports of price concessions and increased discounting on a number of basic raw materials. Additional evidence on this was provided by the September survey of the National Association of Purchasing Management, which reported a continued decline in the proportion of respondents facing higher prices. Moreover, steel manufacturers rescinded a previously announced price hike, while aluminum producers postponed planned price increases. In addition, spot commodity prices dropped considerably in August and September, according to the Bureau of Labor Statistics index.