The Business Situation

The economy drifted unevenly in the second quarter. Industrial production and employment fell throughout the April-June period, although real output of the economy as a whole was virtually unchanged after two quarters of decline, according to the preliminary estimate. Some June indicators furthermore suggested a flattening or perhaps even some renewed advance. Durables new orders and shipments stayed at their improved May level. Housing starts advanced after earlier increases in permits and scattered signs of a better financing picture. Auto sales and output gained further, following a slump last fall and winter that had been an important factor in the economic slowing. Evidently the various Federal actions bolstering personal income within the quarter had their expected effect on spending. Total consumer outlays continued to advance at around the first-quarter rate despite the lack of growth in private wage and salary payments. In July, disposable income was boosted by the expiration of the income tax surcharge and by the increase in the personal exemption. Financial conditions also seem favorable for some renewed growth in real output. The money supply continued to advance at a moderate pace in the second quarter, and financial markets have become noticeably calmer, with substantial declines taking place in a wide spectrum of interest rates over the past several weeks.

Despite some scattered and hopeful signs of improvement in the price picture, solid evidence of a real slowdown in the rate of inflation is still lacking. The apparent sharp reduction in the rate of growth of the GNP deflator during the second quarter largely represented technical factors rather than a real improvement. In July, the wholesale price index jumped sharply as agricultural prices surged. In June and July, some moderation in the rate of advance in wholesale industrial prices mainly reflected seasonal factors. While the rise in the consumer price index slowed to a 4½ percent seasonally adjusted pace in June, such one-month slowdowns have occurred before and subsequently proved to be false signals. Rising productivity in manufacturing has helped to hold down the advance in unit labor costs in that sector, but the pay increases won in recent collective bargaining settlements have far outpaced any conceivable further progress in productivity and extend to industries in which there is no evidence of significant productivity gains. In short, the inflation problem is still very much with us.

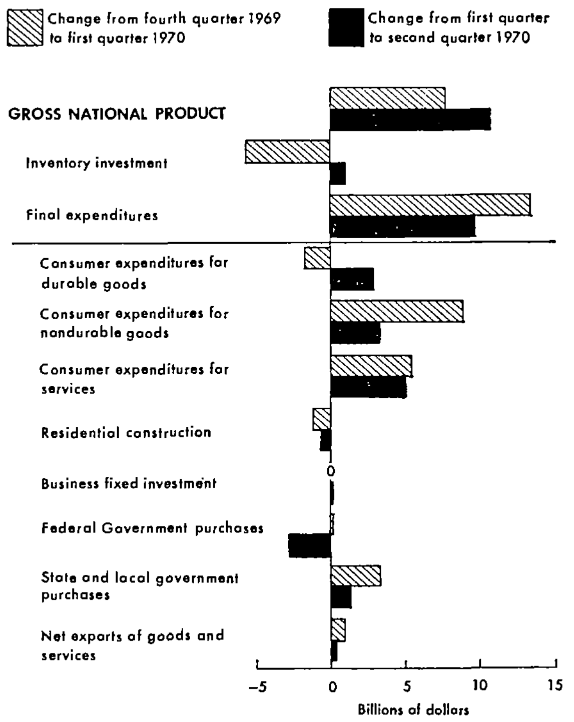
GROSS NATIONAL PRODUCT IN THE SECOND QUARTER

The real value of the nation's output of goods and services was virtually unchanged in the second quarter, although continued price increases led to a rise in the market value of the nation's product. Coming on the heels of two successive quarterly declines, the approximate stability of real gross national product (GNP) in the April-June period gave rise to the hope that the downtrend of the previous six months had ended. According to the preliminary estimate of the Department of Commerce,[1] current-dollar GNP rose by $10½ billion (see Chart I) to a seasonally adjusted annual rate of $970 billion. Excluding price increases, GNP edged up by a scant 0.2 percent annual rate. In the October-March period, real GNP had fallen at a 2.0 percent annual rate.

The GNP deflator—which is the broadest measure of price trends in the economy—rose at a 4 percent annual rate, compared with a 6½ percent increase in the first quarter. This decline did not indicate an easing in basic inflationary price trends, for it mostly reflected technical factors that boosted the rate of advance in the first quarter

[1] The Commerce Department's annual midyear revisions of the national income and product accounts reduced GNP for the fourth and first quarters by $0.5 billion and $0.1 billion, respectively, to seasonally adjusted annual rates of $951.7 billion and $959.5 billion. The GNP estimate for 1969 was revised down by $0.7 billion to $931.4 billion. For 1968, GNP was reduced by $0.7 billion, bringing the total for that year to $865.0 billion. GNP for 1967 was revised up by $0.4 billion to $793.9 billion.

Chart I
RECENT CHANGES IN GROSS NATIONAL PRODUCT AND ITS COMPONENTS
Seasonally adjusted



Source: United States Department of Commerce.

and lowered it in the second quarter. The deflator climbed at an unusually high rate in the first quarter because the Federal Government pay raise, which added nothing to real output, did increase outlays.[2] The lower second-quarter rate largely resulted from a shift in the composition of demand. This change in composition affected the total GNP deflator, which is the weighted sum of deflators for individual components. The weights are equal to each component's share of total GNP in the period under consideration. In the first quarter a relatively large proportion of GNP was spent in components with high deflators, but in the April-June period there was a shift in spending to components having lower deflators. If these technical factors—the shift in the composition of spending and the impact of the pay raise—are ignored, the resulting GNP deflator would have risen at an annual rate of about 5 percent in both quarters. On a monthly basis, consumer prices and industrial wholesale prices rose less steeply as the quarter ended, but it is still too early to tell if this letup indicates a basic change in trend. In June, consumer prices rose at a 4½ percent seasonally adjusted annual rate, compared with a 6 percent rate in the first five months of 1970. The easing reflected a decline in seasonally adjusted food prices. Prices of nonfood commodities and of services—which are much more indicative of inflationary pressures than are food prices—continued to advance sharply. Industrial wholesale prices rose slowly in June, but spokesmen at the Bureau of Labor Statistics attributed the slowdown to seasonal declines. Preliminary data for July indicate that industrial wholesale prices advanced at a faster rate than in June and that there was a big jump in agricultural prices.

The stronger performance of total GNP in the second quarter reflected a turnaround in inventory spending. Based on incomplete data,[3] net inventory spending is estimated to have increased by $1 billion to a $2½ billion annual rate, which is still a very low level of accumulation. The $1 billion increase in April-June followed declines totaling $10 billion in the final quarter of 1969 and the first quarter. While this drag was the main cause of the GNP slowdown in those two quarters, the adjustment was much milder than in the mini-recession of 1967, when inventory accumulation fell by $15 billion in six months. Inventory accumulation was kept at a slow pace over the first half of this year, as businessmen continued to bring stocks into a better line with sales. Inventory-sales ratios—particularly among trade firms—improved over the first two months of the quarter, but some modest imbalances still exist among durables manufacturing firms despite progress during the second quarter in reducing inventory-sales ratios. In general, cuts in inventory spending in response to sluggish sales patterns have prevented any major imbalances in inventory-sales positions from

[2]The pay raise was enacted in April but was made retroactive to January. The retroactive portion of this increase was treated differently in the GNP accounts than it was in personal income. In GNP, the retroactive part was included in first-quarter spending, as if it had been a simple pay raise beginning in January and continuing on at that new level. In terms of personal income, however, the retroactive portion of the raise was included in wage and salary payments for the second quarter, when these payments were actually disbursed. Thus, the increase in personal income in the April-June period reflected the actual pay raise plus a nonrecurring bulge due to the back payments.

[3] In the preliminary GNP numbers, the inventory component is estimated from data for the first two months of the quarter. Thus, this component is particularly subject to revision.

developing. Unless there is a deterioration in sales, the recent adjustment in inventories may prove to have run its course.

Final expenditures, which exclude the inventory component from GNP, advanced at a slower pace than in the first quarter, chiefly because of a moderation in the government sector. Federal Government spending declined by over $2½ billion, with most of this drop arising from cuts in defense spending. A similar decline would have taken place in the first quarter but for the Federal employee pay raise. While expenditures by state and local governments rose in the second quarter, the quarterly increase was the smallest in six years. Spending was dampened by delays in construction projects, which partly reflected the continued financing difficulties faced by many state and local governments and the effects of trucking strikes.

Consumer spending rose by about $11 billion in the second quarter. This increase was actually slightly larger than in the first quarter despite the general weakness in private income payments during the April-June period that resulted from cutbacks in both total employment and the workweek. The impact of these cutbacks was more than offset by two government actions that in fact caused a record increase in personal and disposable incomes in the second quarter. Thus, the Federal pay raise became effective in April and the retroactive portion of the increase was also paid out in April and May. Similarly, there was an increase in social security benefit payments which began in April, with retroactive payments also being made in that month. Without these special factors, personal income would have changed little over the April-June period.

While all broad categories of consumption spending rose in the second quarter, the most notable increase was in the durables sector, where consumer spending had actually fallen in the first quarter of the year. The major factor in this turnaround was the partial recovery of new car sales from their January-March slump. In addition to the renewed growth of auto sales, the outlook for consumer spending in the current quarter is strengthened by the boost to disposable income that resulted from the July 1 expiration of the surtax.

Business fixed investment was about unchanged over the first half of the year. Although recent surveys of plant and equipment spending plans for this year had pointed to a small increase (and earlier surveys to a fairly strong rise), the actual spending figures for the first and second quarters suggest that capital investment may not contribute much to GNP growth this year. Weak profits, the uncertain sales picture, and excess capacity are important factors tending to dampen the near-term outlook for capital outlays. In addition, tight money and the growing concern over corporate liquidity positions may have caused some corporations to reexamine their borrowing and investment plans.

Investment in residential construction was again a drag on the growth of current-dollar GNP, but the second-quarter decline was small—amounting to $½ billion, compared with a drop averaging over $1½ billion in the three previous quarters. The moderate size of the second-quarter easing reflected a bottoming of the downtrend in housing starts. Starts had been falling since the first quarter of last year, when they averaged a seasonally adjusted annual rate of 1.6 million units. Since the January low of 1.1 million units, starts have been stronger—running at an annual rate of almost 1.4 million units in June. Moreover, residential building permits issued by local authorities in the April-June period exceeded the first quarter's average by 20 percent. This series tends to lead starts by several months, and thus the recent strength in permits points to a somewhat more buoyant outlook for residential construction. Improved deposit flows to thrift institutions and the likelihood of increased Federal aid have also enhanced the outlook for the housing sector.

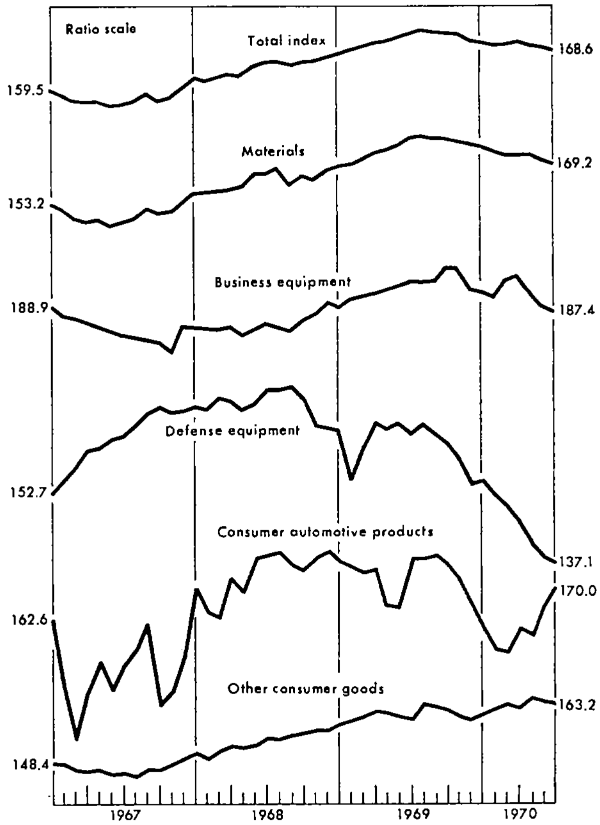
PRODUCTION, PRODUCTIVITY, AND LABOR COSTS

Industrial activity slackened a bit further in June, as declines in equipment and construction materials outweighed increases in production of consumer automotive products. The Federal Reserve Board's index of industrial production slipped 0.3 percent in June to 168.6 percent of the 1957-59 average (see Chart II), bringing the total drop since last July's peak to 3.4 percent.

As in the two previous months, the major decline in the June index was among equipment producers. Defense production fell 0.9 percent and brought the retreat from its 1968 peak to a total of 25 percent. Defense output had soared by 75 percent between early 1965 and its mid-1968 peak. Production of business equipment dropped 0.8 percent in June. Since last October, equipment output has declined by 7 percent, a further indication that the planned rise in outlays indicated by surveys of business spending plans may have been overstated.

Production of materials—particularly for construction—moved down in June, although iron and steel output increased. Seasonally adjusted production of steel ingots advanced again in July, suggesting that the iron and steel index may be continuing to rise. In recent months, iron and steel production has been bolstered by the partial recovery of the automobile industry from the slump last fall and winter. In June, production of automotive products climbed 2.8 percent. This brought the index to a level 10 percent above

Chart II
INDUSTRIAL PRODUCTION
Seasonally adjusted; 1957-59=100



Note: Indexes for defense equipment and nonautomotive consumer goods were calculated at the Federal Reserve Bank of New York from data published by the Board of Governors of the Federal Reserve System. Indexes are not plotted in rank order. Data for latest four months are subject to revision.

Source: Board of Governors of the Federal Reserve System.

the February low, although output was still about 5 percent below the levels prevailing before the slump began. With the improvement in car sales, the outlook for auto production is good. However, labor contracts with the auto makers expire in September, and a strike appears to be at least a possibility.

The flow of new orders for durable goods, an important indicator of business activity, has apparently leveled out. Orders volume had fallen by $3½ billion between last September and March, but in the April-June period orders picked up, erasing $1 billion of that decline. The improvement in new durables orders has not yet reversed the downtrend in the backlog of unfilled orders. In June, shipments volume again exceeded the orders inflow and the backlog fell to the lowest level in almost two years.

The slowing of economic activity has particularly affected the labor markets. The most marked impact on employment has resulted from the decline in industrial activity. Since the July 1969 peak in industrial production, manufacturing employment and the factory workweek have both fallen sharply, with the number of persons on factory payrolls dropping by half a million and the workweek declining almost a full hour. The slump in total man-hours since last July has been greater than the drop in output in manufacturing, resulting in an improvement in manufacturing productivity. Although productivity is likely to grow in the coming months, recent collective bargaining settlements have called for increases in wages and benefits that far exceed any conceivable gains in output per man-hour. In the first half of this year, negotiated wage and benefit increases averaged 10 percent over the life of the contract and 15 percent for the first year.