The Business Situation

Recent developments suggest that the economy may be resuming an expansionary course. Housing starts and building permits showed renewed strength in March, suggesting that further gains in residential construction spending are likely to emerge in the coming months. Similarly, the continued large volume of state and local government bond financing indicates some additional spending thrust from this sector. However, the extent of overall economic growth for the balance of the year depends critically on the behavior of consumer spending. In the first quarter, consumer expenditures as recorded in the gross national product (GNP) accounts posted a large increase which was primarily the result of the rebound in spending on motor vehicles from its strike-depressed fourth-quarter level. However, advance retail sales data for March and some sketchy data for April suggest that consumer outlays for nonautomotive durables, as well as nondurable goods, have been gaining some momentum. In the second quarter, a boost in personal income resulting from increased social security benefits may reinforce this apparent move toward a stronger underlying pace of consumer spending.

Although there were some encouraging developments during the first quarter, a clear trend toward a broad-based moderation of inflationary pressures has not yet emerged. On the positive side, the rate of increase in consumer prices slowed somewhat during the first three months of the year. On the other hand, even allowing for the influence of special factors, the GNP deflator continued to rise at a rapid rate. Prices of wholesale industrial commodities, moreover, spurted sharply in April after having moderated in the first quarter. Furthermore, compensation per man-hour increased by about 7 percent over the past year, a rate of gain which has not abated despite the marked rise in unemployment.

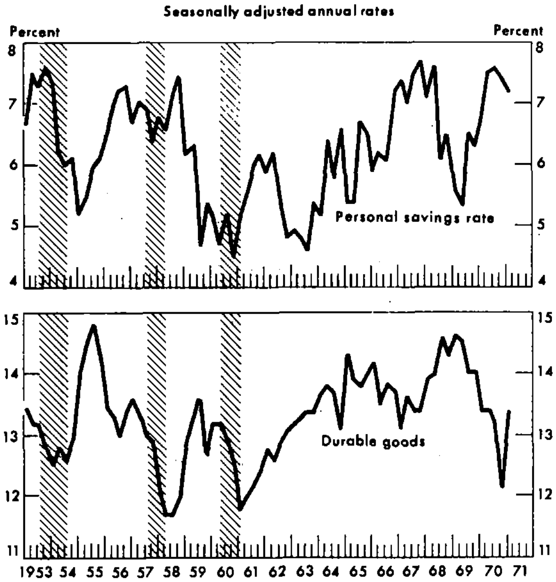
GROSS NATIONAL PRODUCT

A $28.5 billion rise in the market value of the nation's total output of goods and services during the first quarter raised GNP to a seasonally adjusted annual rate of $1,018.4 billion, according to the preliminary estimates of the Department of Commerce. Just as the previous quarter's GNP had been depressed by the General Motors strike, the first-quarter gain in GNP was swelled by the rebound of activity from the strike. The average quarterly increase in GNP over the two quarters was a modest $16.5 billion. Real GNP rose at a seasonally adjusted annual rate of 6.4 percent in the first quarter in 1971, with the gain in automotive production more than accounting for the increase. Over the two quarters ended in March, real GNP rose at a very low annual rate of 1.1 percent.

The first-quarter increase in final expenditures—that is, GNP less the inventory component—amounted to almost $30 billion, with 60 percent of that gain arising from the consumer sector. The overall gain in consumer spending reflected higher outlays for durable and nondurable goods as well as for services. The rise in consumer outlays for services was in line with recent experience, while the gain in purchases of nondurables was of modest proportions. On the other hand, durables spending increased by a large $10.8 billion, a gain of 12.7 percent. This expansion in durable goods expenditures pushed the ratio of consumer durables outlays to disposable income to 13.4 percent. In the past, similar movements in this ratio have tended to signify a cyclical strengthening in the economy (see Chart I). However, inasmuch as virtually all of the first-quarter strengthening in durables spending reflected the recovery in automobile sales from their strike-depressed fourth-quarter level, these first-quarter data do not indicate a firm trend. There were indications, however, that consumer spending on nonautomotive durables as well as on nondurable goods was quickening toward the end of the quarter.

Although there was a large overall first-quarter gain in consumer spending, the savings rate declined by only 0.2 percentage point to 7.2 percent—still about 1 percentage point above its average level for the last two decades (see Chart I). The high savings rate, coupled with the large rise in consumer outlays, was made possible by the gain in disposable personal income in the first three months of 1971. Indeed, fueled by higher personal income payments

Chart I
PERSONAL SAVINGS AND DURABLE GOODS CONSUMPTION AS A PERCENTAGE OF DISPOSABLE INCOME
Seasonally adjusted annual rates



Note: Shaded areas represent recession periods, according to the National Bureau of Economic Research chronology.
Source: United States Department of Commerce.

including the Federal pay boost and by the lower Federal income tax withholdings which took effect on January 1, 1971, disposable income jumped by almost $18 billion. In the current quarter, moreover, both personal income and disposable income will be stimulated further by the large increase in social security benefits that was recently signed into law. This added flow of income raises the possibility that consumer spending will provide additional upward thrust to economic activity in the coming months.

Residential construction spending and outlays by state and local governments, both of which have benefited from improved financial market conditions, were also major sources of strength in the overall first-quarter rise in final demand. For example, spending on residential construction rose by $3.2 billion, bringing the cumulative increase in this spending component over the last three quarters to $7 billion or 25 percent. Moreover, additional gains in residential outlays are likely in the months ahead. For example, after having leveled off in February, housing starts and building permits showed renewed strength in March. Perhaps more importantly, the availability and cost of mortgage credit continued to improve dramatically. During the first quarter, deposit flows to the nation's thrift institutions—the major suppliers of residential mortgage credit—amounted to a record 23 percent on a seasonally adjusted annual rate basis. The effective interest rate on conventional mortgages declined to 7.66 percent in March, 86 basis points below the record high of 8.52 percent reached in August 1970. In addition, over this seven-month period, the loan-price ratio on these mortgages increased, indicating a lowering in downpayment requirements for borrowers.

Improved capital market conditions were also instrumental in the first-quarter surge in purchases of goods and services by state and local governments that amounted to $4.9 billion. Indeed, while payroll costs of these governmental units continue to show a strong upward trend, the overall rise in spending has been given added thrust by the record volume of debt that has been marketed in the last several months. For example, in the nine-month interval ended in March 1971, the tax-exempt bond market absorbed an estimated $16.8 billion in new state and local bonds, up 42 percent over the amount issued in all of 1969. Many of these issues had been scheduled for marketing in 1969 or earlier in 1970 but were postponed because of high interest rates and generally unfavorable credit market conditions. The bonds issued over the last nine months have implications for spending well beyond their contribution to the first-quarter increment in state and local outlays. Inasmuch as most of these issues are used to finance capital projects—new structures, roads, sewers, and the like—their full impact on spending involves a lag of at least several quarters.

Business fixed investment spending rose by $3.8 billion in the first three months of 1971, the largest such gain since the third quarter of 1969. Much of this strength was merely a reflection of the rise in business purchases of automobiles and trucks from the strike-depressed fourth-quarter level. Apart from strike-related factors, business fixed investment expenditures were higher, primarily because business outlays for structures posted a large gain in the first quarter after having declined in four of the preceding five quarters. While these first-quarter data on business investment spending may show a bit of improvement relative to the experience of the last several quarters, the underlying situation for this spending component remains on the sluggish side. The latest survey by McGraw-Hill on corporation plant and equipment expenditures indicated a modest 4 percent increase for this year. This increment is in line with the rise indicated in the recent survey by the Department of Commerce-Securities and Exchange Commission as well as the survey by Lionel D. Edie.

Net exports and Federal Government purchases of goods and services, the remaining two components of final demand, were virtually unchanged in the first quarter.

Net exports expanded by $0.2 billion, while Federal purchases fell by $0.1 billion. The decline in Federal outlays, which occurred in spite of the $2.2 billion pay increase that took effect in the period, reflected the continuing decrease in defense purchases.

On the basis of preliminary data, the rate at which businesses accumulated inventories declined slightly in the first quarter, thereby serving as a restraint on the overall expansion of GNP. The buildup of automobile inventories by dealers who were replenishing their strike-depleted stocks accounted for the inventory investment that did occur, indicating little change of inventories in other sectors. The lack of any accumulation of nonautomotive stocks has created a better balance between the level of inventories and the corresponding volume of sales. With the resulting lower inventory-sales ratio, a pervasive upsurge in sales activity would tend to promote a more expansionary pace of inventory spending.

PRICES, LABOR COSTS, AND PRODUCTIVITY

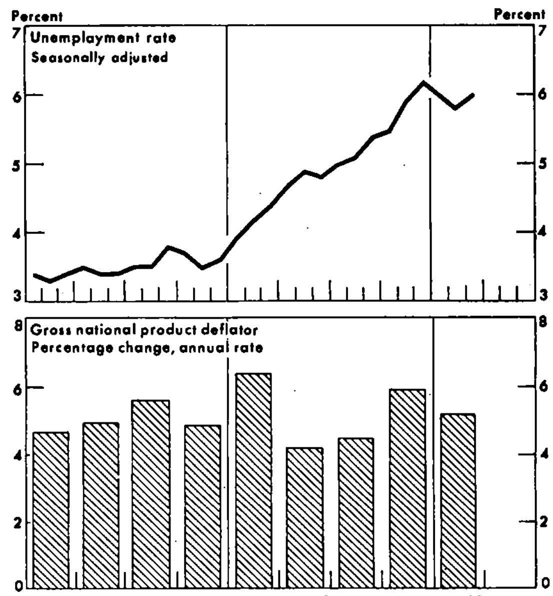
Taken as a whole, the performance of prices has continued to be unsatisfactory, although recent movements in consumer prices have been encouraging. Compared with a 5.5 percent annual rate of increase during 1970, the consumer price index (CPI) rose at a 2.7 percent annual rate in the first three months of 1971. The implicit GNP price deflator rose at a seasonally adjusted annual rate of 5.2 percent in the first quarter of 1971, little changed from the performance of other recent quarters (see Chart II). In fact, because the weights used in calculating the deflator are based on the current composition of output and because there was a first-quarter output surge in the automotive industry—a sector with a low deflator—the rate of increase in the deflator was restrained. For example, using the output weights of the fourth quarter of 1965, the annual rate of increase in the GNP price deflator climbed from 5.1 percent in the last quarter of 1970 to 5.9 percent in the first quarter of 1971. In part, the disparity between the first-quarter performance of the GNP deflator and of the CPI can be attributed to their different coverage. For example, the Federal pay raise added to the GNP deflator without directly affecting the CPI. Moreover, lower interest rates on home mortgages and lower used-car prices, which were major factors in the moderating trend in consumer prices, do not directly influence the GNP deflator. The rapid increase in the GNP deflator suggests that a firm trend toward a more satisfactory price performance has not yet been established. This was underscored by a sharp spurt in industrial wholesale prices in April after more moderate increases in the first quarter. Over the first four months of 1971, industrial wholesale prices advanced 3.7 percent on a seasonally adjusted annual rate basis, virtually the same as the increase registered in 1970 as a whole.

The events of the past year with respect to the observed relationship between the rate of inflation and the level of unemployment seem to run contrary to the post-Korean war experiences. Since the beginning of 1970, the unemployment rate has risen from 3.9 percent to about 6.0 percent, while the rate of inflation as measured by the GNP deflator has remained at about 5 percent (see Chart II). This apparent deterioration in the trade-off between inflation and unemployment may reflect several considerations, such as the duration and intensity of the inflation since 1965 which may have changed expectations of price movements. In addition, there have been demographic shifts in the composition of the work force. For example, the relative number of 16- to 24-year olds in the work force—a group with a high unemployment rate—has increased substantially in the past decade.

Whatever the significance of such factors in explaining the failure of the general price level to respond more quickly to the sluggishness in the economy, the situation

Chart II

UNEMPLOYMENT AND INFLATION



Sources: United States Department of Labor, Bureau of Labor Statistics, and the United States Department of Commerce.

is even worse in terms of the degree to which labor prices have failed to respond to the marked rise in unemployment. In the first quarter, compensation per man-hour in the private economy, measured from a year earlier, rose by a rapid 7.3 percent. Moreover, the increase in compensation per man-hour over the last three years has remained in the neighborhood of 7 percent. Thus, there is no evidence of a slowing in the rate of increase in this broad measure of labor costs per man-hour.

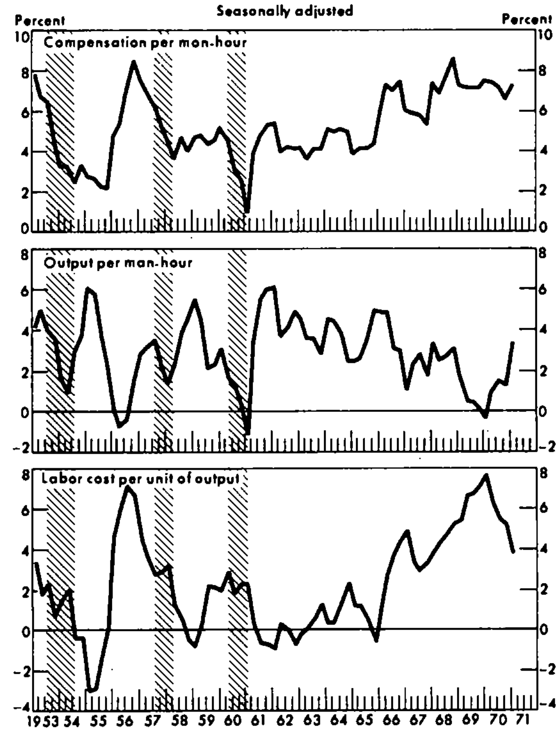
While the rate of increase in compensation per man-hour was essentially unchanged in the first quarter, output per man-hour did register a strong showing. Measured from a year earlier, the growth in this measure of productivity for the private economy was 3.4 percent. This was the strongest productivity increase in three years and was about equal to its long-term trend rate of growth (see Chart III). Over the last year, there has been a movement toward a cyclical strengthening in productivity which, of course, tends to absorb some of the rise in labor costs. However, even with the strong first-quarter gain in productivity, unit labor costs continued to rise rapidly, posting a 3.8 percent gain over the level which prevailed a year earlier. While this represents a significant improvement over the experience of the past three years, it should be noted that, around cyclical upturns in business activity, an increase in unit labor costs as high as 3.8 percent is virtually without precedent. Thus, the strengthening in productivity to date has not been sufficient to stabilize unit labor costs, primarily because the rise in compensation per man-hour has not moderated in response to the slowing of economic activity.

Chart III

LABOR COMPENSATION, PRODUCTIVITY, AND UNIT LABOR COST IN THE PRIVATE ECONOMY

CHANGE FROM FOUR QUARTERS EARLIER

Seasonally adjusted



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

Moreover, the first-quarter data on major labor contract settlements provide little basis for hope of a significant decline in the rate of increase in compensation rates. For example, the contracts negotiated in the first quarter provided for an 8.5 percent increase in wages and fringe benefits over the life of the contract for the 600,000 workers whose representatives signed settlements in this period. While this represents a very slight moderation from the gain of 9.1 percent registered in 1970, the first-quarter increase is still extraordinarily large by historical standards. Of course, contract settlements in the current year tell only part of the story, since a large segment of the workers covered by these major contracts will receive wage adjustments in 1971 on the basis of contracts written in the last year or two. In the current year, almost half of the 10.9 million workers covered by major collective bargaining agreements will receive deferred wage increases averaging 7.8 percent, compared with a 5.6 percent average deferred increase won in 1970. The 7.8 percent figure does not include any wage adjustments that will materialize on the basis of cost-of-living escalation provisions which, in turn, will influence wage rates for about 3 million workers this year. In short, viewed in terms of either the behavior of compensation per man-hour or recent developments in labor contract settlements, wage inflation is still a very serious problem.