The Business Situation

There are increasing signs that the economy is emerging from last year's recession. Restrained inventory spending and gains in sales have substantially improved the balance between stocks and sales, and thus stepped-up inventory spending could soon provide some additional stimulus to the economy. Also, the rebound in residential and public construction appears firmly established, and activity in the industrial sector—while still mixed—seems to have picked up a bit even outside the automobile and steel industries. The indications of an underlying strengthening in economic activity are still limited, however, a fact that is underscored by the softness in personal income and new orders for durable goods in April.

There have been some encouraging developments on the price front, but the pace of inflation remains swift. Thus, while consumer nonfood commodity price increases have moderated significantly over the four months ended in April, a sizable part of the slowing in the overall consumer price index reflects the dramatic fall in home mortgage interest rates. At the same time, industrial wholesale prices rose sharply in April and May. For the first five months of the year these prices advanced at an even higher rate than that experienced in 1970. Moreover, recent announcements of further price advances for a number of metals and metal products underscore the likelihood of continued upward pressure on industrial wholesale prices and, eventually, prices of consumer goods.

PRODUCTION AND ORDERS

Led by a strong increase in iron and steel production, the pace of industrial activity again rose in April, as the Federal Reserve Board's index of industrial production advanced 0.3 percent. By April, the index had risen 2.8 percent from its recent November low but was still 4.9 percent below the July 1969 peak. Close to one third of the recovery in the last five months reflects rising output in the steel industry, where inventory stockpiling as a hedge against a possible July 31 strike has been sizable. A little better than another third of the advance since November reflects increased automobile output following the end of the strike at General Motors.

Aside from the automotive and steel industries, recent trends in production have been mixed, though output was up on balance in April. Production of consumer goods other than automobiles has moved up rapidly in the last two months. However, the long downtrend in both business and defense equipment production has continued. Moreover, the latest survey of business plans for plant and equipment investment, taken by the Department of Commerce and the Securities and Exchange Commission in late April and May, indicates such spending will rise this year by only 2.7 percent, and that on a real basis spending will decline. Thus, there seems to be little prospect for a pickup in business equipment output in the near future.

The recovery in automobile sales has been less than had been anticipated by many industry observers. Sales of domestic automobiles, which had dropped to a 5.8 million unit seasonally adjusted annual rate during September through December of last year, have fluctuated narrowly around an annual rate of 8.3 million units during the first five months of 1971 (see Chart I). While this was above the pre-strike sales rate which averaged 7.8 million units in the first eight months of 1970, it remained below the 8.5 million unit average of the previous two years. One factor accounting for the relatively modest pace of domestic passenger car sales in recent months may be the strength of imported car sales. Over the October-April period, imported car sales ran at a seasonally adjusted annual rate of 1.5 million units, well above the 1.2 million units averaged in the first nine months of last year.

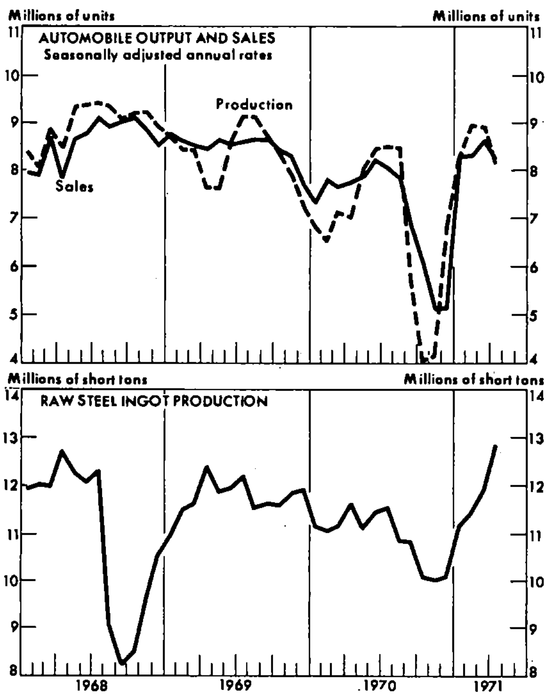
In contrast to the relatively flat trend that has prevailed in the automotive industry this year, steel output has climbed rapidly in response to inventory stockpiling demand. However, production is expected to fall off sharply after midsummer—whether a strike occurs or not

—as steel users work off their surplus stocks. In the previous two steel contract cycles, when strikes were also feared, the peak in production occurred in May and in the following two months the mills concentrated on finishing and shipping. In both cases, there was no strike but production fell drastically after the new contracts were signed. The current inventory buildup has not been especially large. Indeed, it appears about the same or perhaps even a bit smaller than the 1968 experience. The somewhat smaller inventory buildup, the weak demand by capital goods and commercial building industries, and the only moderate demand by car makers have helped keep production levels down below their 1968 record. In the first five months of 1968, raw steel ingot production averaged 12.3 million tons a month, compared with 12.0 million tons in the same period this year.

The big drop in new orders for durable goods in April underscored the hesitant nature of the recovery in the industrial sector. In that month, total orders fell $1.2 billion, with volume for transportation equipment plunging $0.7 billion. A sharp drop in automobile orders from an abnormally high March level and a decrease in aircraft orders were the major factors in this unusually large transportation equipment decline. Prior to the April performance, the overall orders series had been moving up strongly from its recent October low. Most of this strength was due to the auto recovery, although orders received by other manufacturers also rose.

Chart I

OUTPUT AND SALES OF DOMESTICALLY PRODUCED AUTOMOBILES AND PRODUCTION OF RAW STEEL INGOTS



Sources: Automobile output and sales data are from Ward's Automotive Reports. Steel data are from the American Iron and Steel Institute. All data are seasonally adjusted at the Federal Reserve Bank of New York.

CONSTRUCTION

In contrast to the still somewhat mixed picture in the industrial sector, construction activity has picked up on a broad front. In the first four months of this year, outlays for new construction (seasonally adjusted) have run 11.8 percent above the 1970 average. Private residential housing has accounted for almost two thirds of this gain, but renewed strength in public construction—which includes such projects as roads, schools, and hospitals—also contributed to the overall advance.

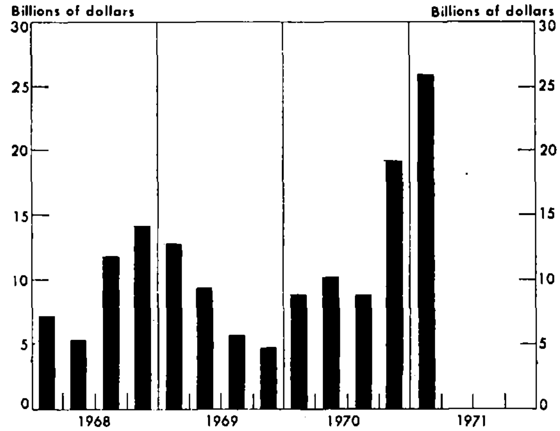
The easing in financial conditions since mid-1970 has been a major factor behind the strength in both private residential and public construction. In the public sector, spending had been dampened by the postponement of many state and local bond issues in the past two years, when market interest rates soared to record levels. In many cases these levels exceeded the statutory limits on the rates these borrowers could pay. The subsequent declines in interest rates were accompanied by a phenomenal increase in capital market borrowing by state and local governments (see Chart II). Borrowing surged in the fourth quarter of last year and then climbed by another 35 percent in the first three months of this year. Indeed, state and municipal net borrowing in the credit markets in the first quarter of this year was two and one-half times the year-ago amount. This suggests that further gains in public construction spending are very likely.

The residential mortgage market has also improved markedly. Deposits at savings institutions rose strongly in the second half of 1970 and then in the first quarter jumped by an unprecedented 21 percent (see Chart III). During the same period, mortgage loans held by these institutions rose 8.9 percent. The relatively large spread between the rate of growth of deposits and the growth of mortgage lending reflects several considerations. Part of the huge flow of deposits has been used to rebuild liquidity positions and, in the case of member savings and loan associations, to repay previous borrowings from the Federal Home Loan Banks. In addition, a relatively large volume of the recent deposit flows has been used by mutual savings banks to make investments in high-grade corporate bonds. However, even allowing for these factors, the surge

Chart II

NET BORROWING BY STATE AND LOCAL GOVERNMENTS

Seasonally adjusted annual rates



Note: First-quarter 1971 data are preliminary.

Source: Board of Governors of the Federal Reserve System, Flow of Funds.

in deposits at the thrift institutions has been large enough to provide ample funds for further increases in mortgage lending. Underscoring this fact, outstanding mortgage commitments at all savings and loan associations and at New York State mutual savings banks rose to a record total of $12.5 billion in March. Indeed, for the first quarter as a whole, outstanding commitments averaged $10.9 billion, up 16.7 percent from the fourth-quarter average. The vigorous tone in residential construction has also been evident in the recent performance of housing starts and, to a lesser extent, of building permits. In March and April, housing starts ran at a seasonally adjusted annual rate of over 1.9 million units, compared with a 1970 total of less than 1.5 million units. Moreover, during these same two months, the volume of building permits issued by local authorities averaged more than 20 percent above the 1970 average.

BUSINESS INVENTORIES AND SALES

Businesses have continued to accumulate inventories at a modest pace and that, together with the recent strengthening in sales activity, has generated a marked improvement in inventory-sales ratios. The lower level of these ratios at the end of the first quarter has possibly paved the way for a more expansionary pace of inventory spending if sales continue to advance. Inventory accumulation, as reported in the gross national product (GNP) accounts, fell from the relatively moderate seasonally adjusted annual rate of $5.5 billion in the third quarter of 1970 to $3.6 billion in the fourth quarter and to $1.4 billion in the first three months of this year.[1] The first-quarter figure was inflated by the rebuilding of strike-depleted stocks in the auto industry and by strike-hedging gains in steel inventories. Excluding these special factors, inventory accumulation was negative. In April, the book value of inventory spending by manufacturers (the only April component now available) recorded a small increase following two months of decline.

The broad-based improvement in inventory-sales ratios has resulted from a better sales picture as well as from the reduced rate of inventory accumulation. In manufacturing, shipments advanced by a monthly average of $650 million in the first four months of the year. Excluding shipments of the recovering automotive industry, sales were still up strongly. At retail, there are some indications of a revival in consumer demand. Following the lackluster performance of 1970 that continued into the first two months of this year, sales at retail outlets recorded a big —and broadly based—jump in March, and then advanced further in April.

PERSONAL INCOME AND EMPLOYMENT

A number of special factors have buoyed personal income in recent months. Excluding these factors, however, growth of personal income has been on the weak side. During the first quarter, the strike recovery and the Federal pay raise helped to lift the average monthly income advances to a $6.4 billion rate, almost twice the 1970 average increase. However, in April, personal income rose only $4.5 billion despite a $1.2 billion rise in transfer payments.

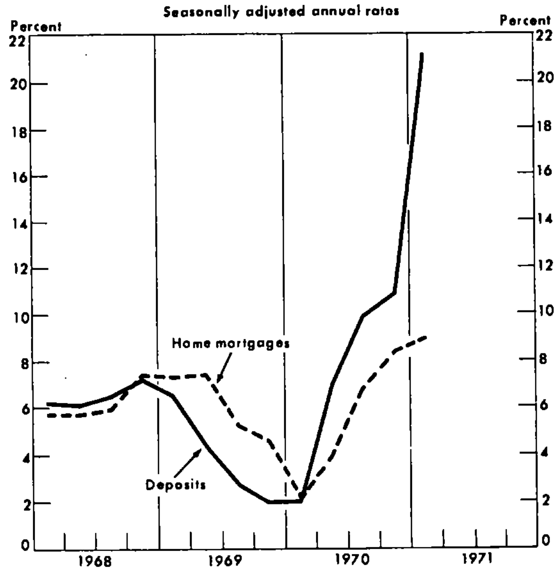
Wage and salary disbursements have been held down by the weakness in the labor markets in the last year or so. As is typical in a downturn, employment in the manufacturing sector has been most affected, and has generally been declining since the summer of 1969. In May the total number of persons on the payroll in manufacturing

[1] In its revised estimate of first-quarter GNP, the Department of Commerce reduced its estimate of inventory spending by $1.0 billion to $1.4 billion. Personal consumption expenditures were revised up by $1.7 billion. Other components were little changed but, when combined, added another $1.6 billion. Total GNP was thus revised up by $2.3 billion to a seasonally adjusted annual rate of $1,020.7 billion. On a real basis, however, GNP was revised up by only $1.1 billion to $732.7 billion. The implicit price deflator is now estimated to have risen by 5.6 percent in the first quarter rather than the 5.2 percent originally estimated.

was 1.6 million below the September 1969 peak. Throughout the recession there has been some growth of jobs outside manufacturing, but this has not been large enough to offset the declines in factory payrolls. Thus, total employment is still below its March 1970 peak.

According to the employment series based on a survey of households rather than firms, the unemployment rate rose to 6.2 percent in May, after averaging 5.9 percent in both the final quarter of 1970 and the first three months of 1971. The rise in the unemployment rate was entirely due to a surge in labor force growth in April and May, as employment increases in those two months were relatively good. While civilian labor force growth in the past two months has been strong, the increase over the first five months of 1971 as a whole ran at a moderate 1.6 percent seasonally adjusted annual rate. The rise in the civilian labor force over that period did not exceed employment increases by a wide margin, and the relatively narrow gap between the two prevented the unemployment rate from rising substantially further than it did. During a recesion, there is typically a decline in labor force participation rates, which tends to dampen labor force growth. The civilian work force probably would have risen even more slowly this year but for the reductions in armed forces personnel. Military cutbacks also boosted civilian labor force growth in 1969 and 1970. During those two years the civilian labor force grew by a rapid 2½ percent per annum. The number of persons on active military duty in the armed services had peaked at 3.5 million in June 1969, fell to 3.1 million by June 1970, and is estimated to be 2.7 million in June of this year. Based on the Federal budget estimates for fiscal 1972, armed forces personnel on active duty will number 2.5 million in June of next year.

Chart III
GROWTH OF DEPOSITS AND HOME MORTGAGE LOANS AT SAVINGS INSTITUTIONS
Seasonally adjusted annual rates



Note: First-quarter 1971 data are preliminary.
Source: Board of Governors of the Federal Reserve System, Flow of Funds.

RECENT PRICE DEVELOPMENTS

The rate of increase of the overall consumer price index slowed in the December-April period to a seasonally adjusted annual rate of 2.9 percent, compared with a 5.5 percent rise for all of 1970. All of this slowing resulted from an improvement in nonfood commodity prices and mortgage interest rates. Elsewhere prices have continued to rise sharply, particularly in the food component where the advance in the first four months of the year amounted to a seasonally adjusted annual rate of 7.0 percent. The recent behavior of consumer nonfood commodity prices has been encouraging. These prices have risen at a seasonally adjusted annual rate of 1.3 percent so far this year, down sharply from last year's advance of almost 5 percent. In terms of slowing the overall index, the fall in home-mortgage interest rates this year was even more important than the easing in the rate of increase of nonfood commodity prices. Excluding this decline in mortgage rates, the overall price index has shown some improvement over last year's performance, but the moderation is not nearly so dramatic as it might otherwise appear.

The recent slower rates of consumer price increases have been cited as evidence of some dampening of inflationary trends. However, the wholesale price situation has remained wholly unsatisfactory and, until there is a clear moderation in the trend of these basic prices, the conclusion that an overall slowing has begun would seem premature. For the first five months of this year, increases in a broad spectrum of industrial goods—such as steel, copper, coal, and lumber—have kept industrial wholesale prices rising at a seasonally adjusted annual rate of 4.0 percent. This rate is even higher than the 3.6 percent increase recorded for all of 1970. Moreover, the stability of agricultural prices which characterized 1970 appears to be over. The wholesale price index for farm products, processed food, and feed rose at a seasonally adjusted annual rate of 7.4 percent over the five months ended in May of this year, compared with a decline of 1.1 percent last year.