The Business Situation

The pace of the economic expansion has shown some modest signs of quickening in recent months, although the overall progress of the recovery remains uneven. To a considerable extent, the stepped-up rate of activity has been grounded in the greater volume of retail sales. Prospective increases in personal disposable incomes—stemming in part from the reductions in tax liabilities in 1972 that were enacted on December 10—should provide further impetus to consumption expenditures and, eventually, to other areas of the economy as well. Beyond that, the agreement among the Group of Ten industrial nations (for details, see page 7) should stimulate production by relieving some of the uncertainties in international trade. New orders for durable goods posted a sizable gain in November, and the backlog of unfilled orders rose by the largest amount in almost a year. Moreover, the underlying demand for inventories also appears to have increased somewhat during recent months. The unemployment rate, on the other hand, edged up slightly to 6.1 percent in December.

Most of the available data on prices and wages continue to reflect the influence of the ninety-day freeze, which ended November 13. Between August and November, the increase in prices of nonfood consumer commodities halted while industrial wholesale prices actually fell slightly. At the same time, the advance of workers' hourly wage rates slowed dramatically from the sizable rises posted earlier in 1971. Under Phase Two, subsequent developments will reflect the guidelines and decisions of the Price Commission and the Pay Board. However, rather large recorded rises in wages and prices are to be expected in December and January, as some increases delayed by the freeze are superimposed upon those that would have normally occurred.

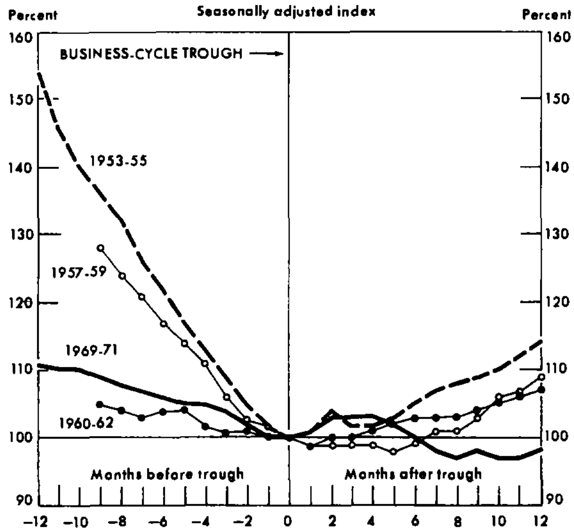
PRODUCTION, ORDERS, AND INVENTORIES

The Federal Reserve Board's index of industrial production rose by a substantial 0.8 percent in November. Although about one quarter of the rise in output during November was attributable to the settlement of the coal miners' strike, the rest of the advance was widely distributed among the major industrial and market groupings, with large increases occurring in the output of consumer nondurables and business equipment. Despite the expansion in the production of business equipment, the output of durables manufacturing industries overall showed very little change in November and remained almost a full percentage point below its recent high attained in May 1971. Indeed, the absence of any appreciable strengthening in durables production since November 1970, which has tentatively been dated by the National Bureau of Economic Research as the cyclical trough, has been a major factor underlying the slow pace of the current economic recovery.

In contrast to the small rise in durables production in November, new orders for durable goods jumped 4.3 percent on a seasonally adjusted basis, after having risen by a much smaller amount in the previous month. While the volatility of this series argues against attaching a great deal of significance to this most recent gain, special factors may have obscured any improvement in the underlying demand for durable goods during earlier months. For example, the November spurt in new orders may have stemmed partly from the lifting of the price freeze. During the time that the freeze was in effect, some buyers and sellers may have been reluctant to enter into firm agreements until a clearer picture of the Phase Two wage and price policies had emerged. Another factor that has tended to depress new orders during recent months has been the rundown in steel stocks that had been built up by users in anticipation of a midsummer steel strike. With the sharp November advance, durables orders exceeded shipments and the backlog of unfilled orders swelled by $400 million on a seasonally adjusted basis, the largest gain since January 1971.

Taking a somewhat longer perspective, the growth in new orders for durable manufactured goods was relatively modest and quite uneven in the twelve months after the cyclical trough. While durables orders were almost 18 percent higher in November 1971 than they had been one year earlier, this increase was in fact smaller than the

Chart I
UNFILLED ORDERS OF DURABLES MANUFACTURERS IN FOUR CONTRACTIONS AND RECOVERIES
Seasonally adjusted index



Note: The business-cycle troughs, as identified by the National Bureau of Economic Research, are August 1954, April 1958, February 1961, and November 1970 (tentative).

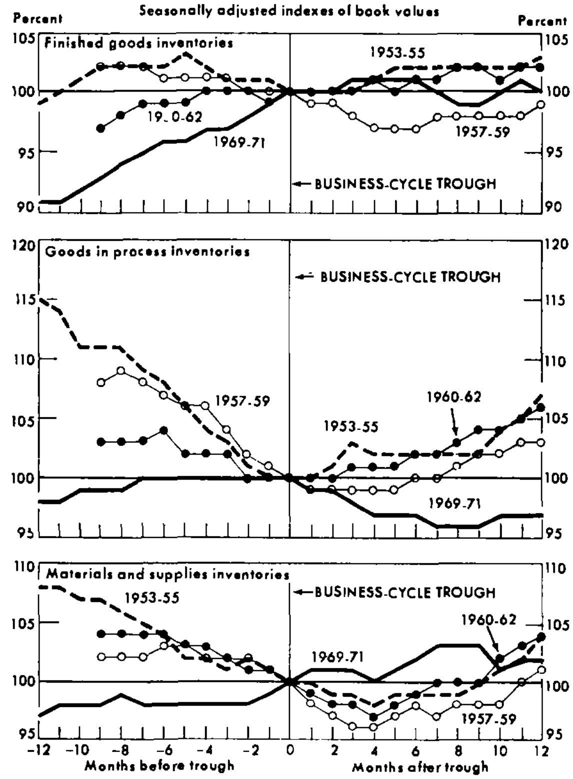
Source: United States Department of Commerce, Bureau of the Census.

gains experienced during comparable periods of recovery from any of the three earlier post-Korean war recessions, when the increases ranged from 20 percent to nearly 50 percent. Indeed, the weakness of the current recovery is even more pronounced than this comparison suggests, since the level of orders in November 1970 was depressed by the General Motors strike, then in its third month. The backlog of unfilled orders for durable goods rose slightly during the opening months of 1971 but retreated thereafter. Despite the advance in November, unfilled durables orders were still 2.3 percent below the level of twelve months earlier and were fully 12.4 percent below the peak attained in July 1969. In comparison, in the three previous post-Korean war recoveries the orders backlog had grown substantially in the year following the cyclical trough (see Chart I).

The relatively cautious scale of inventory investment spending by manufacturers has contributed importantly to the slow pace of the current economic recovery, primarily reflecting the outright declines in the stock of goods in process (see Chart II). In previous recoveries, these inventories had registered fairly strong growth; in the current recovery, however, they continued to fall long after the cyclical trough had been passed. These declines have to some extent been related to the failure of unfilled orders to begin a sustained and pervasive rise. The stock of goods in process was gradually diminished as durable goods continued to be finished and shipped at a faster rate than they were being replaced by new orders. In contrast, the accumulation of materials and supplies, though dominated by the buildup and subsequent rundown of steel stockpiles, does not appear to have been otherwise very different from previous recovery periods. Similarly, the behavior of finished goods inventories has been roughly in line with the performance in earlier comparable periods.

Following the outright declines in earlier months, manufacturers have begun to add to their inventories in recent months. Between August and November, the stock of finished goods inventories, measured on a seasonally adjusted book-value basis, increased by about $400 million, while that of goods in process swelled by a bit more than $630

Chart II
MANUFACTURERS' INVENTORIES IN FOUR CONTRACTIONS AND RECOVERIES
Seasonally adjusted indexes of book values



Note: The business-cycle troughs, as identified by the National Bureau of Economic Research, are August 1954, April 1958, February 1961, and November 1970 (tentative).

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

million. Each of these components had fallen quite sharply during the previous three-month period. Reflecting the rundown of the excess steel inventories, the book value of materials and supplies declined by almost $550 million between July and September. However, it appears that this inventory correction may have run its course, inasmuch as the stock rose slightly in October and was virtually unchanged in November. Indeed, the volume of new steel orders increased in November. Taken together, these data suggest that inventory investment spending by manufacturers had begun to strengthen in the closing months of last year.

PERSONAL INCOME AND RETAIL SALES

Personal income posted a modest increase of $3.5 billion in November, rising to a seasonally adjusted annual rate of $876.0 billion. Virtually all of this growth in personal income was accounted for by a $3.1 billion increase in wage and salary disbursements, one third of which was, in turn, attributable to the military pay raise that took effect at midmonth. The small size of the November expansion in private wage and salary disbursements was, in part, indicative of the limited increases in employment and hours worked that occurred during the month. The wage freeze was an additional factor, however, as a sizable portion of the data used to estimate personal income was collected before the freeze had been lifted. Over the three-month period that ended in November, the average monthly gain in wage and salary disbursements was only $1.7 billion.

The relatively small increase in personal income in recent months has not had a dampening impact on consumer spending. On the contrary, buoyed by an apparent improvement in consumer confidence as well as by consumers' anticipations of price hikes after the freeze, retail sales advanced at a seasonally adjusted annual rate of 18 percent over the four months that ended in November. While part of this advance resulted from the widely publicized surge in automobile sales, the gains in retail buying were broadly based, with sales of both nondurables and nonautomotive durables growing appreciably. Over the same four-month period, nondurable retail sales increased at a 11 percent annual rate while nonautomotive durables sales soared 22 percent. These growth rates were more than double those experienced in the first half of 1971. Moreover, since this sizable expansion in current-dollar retail sales occurred over the period in which the price freeze was still in effect, rising prices accounted for a much smaller share of the overall advance in the dollar volume of sales than was the case earlier in the year.

EMPLOYMENT, WAGES, AND PRICES

In December, labor market conditions showed little change as the unemployment rate inched up 0.1 percentage point to 6.1 percent. Thus, the unemployment rate at the end of 1971 was virtually unchanged from the reading registered at the close of 1970. To be sure, employment based on the household survey has shown some improvement in recent months. In the October-December period, for example, the average level of civilian employment exceeded the third-quarter average by 780,000 workers. However, since this gain was roughly matched by a large increase in the labor force, the unemployment rate was essentially unchanged. In contrast to the household survey, the nonagricultural payroll survey showed only modest employment gains in December and the fourth quarter. In the key manufacturing sector, in particular, employment showed little change as producers were apparently able to meet their additional labor requirements by a slight lengthening of the workweek.

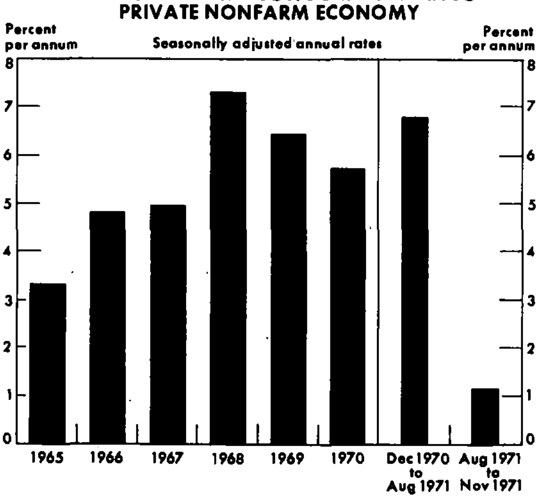
Wage data for recent months indicate that the ninety-day freeze was quite effective in braking the speed at which wage rates had been climbing. Within the private nonfarm economy, the average hourly earnings of production and nonsupervisory workers rose at a seasonally adjusted annual rate of only 1.2 percent between August and November (see Chart III). This time span approximately corresponds with the freeze period, since the August survey was taken in the week before the freeze was announced while the November survey was taken in the week prior to the expiration of the freeze. Most, if not all, of this rise probably stemmed from increased overtime and job shifts within firms or between firms in the same industry and other compositional shifts among the employed work force. In comparison, over the first eight months of the year, these workers' average hourly earnings had been surging ahead at a 6.9 percent annual rate.

In coming months, wage developments will be heavily influenced by the guidelines and decisions of the newly established Pay Board. Soon after its appointment, the Pay Board announced that its broad objective would be to limit the increases in total employee compensation to an annual rate of 5.5 percent—though its initial decisions have permitted considerably larger rises. This guideline notwithstanding, it appears likely that average hourly earnings[1]

[1] Because the average hourly earnings figures exclude some fringe benefits and other wage supplements, such as health insurance and contributions to retirement, they are less comprehensive than total employee compensation.

Chart III

CHANGES IN AVERAGE HOURLY EARNINGS
PRIVATE NONFARM ECONOMY



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

will show relatively large increases in December and January as a result of a clustering of wage hikes—including some retroactive ones—that would otherwise have occurred during the months covered by the freeze. Many workers, for example, were scheduled to receive merit pay raises and deferred wage boosts between August 15 and November 13. Similarly, negotiations on some new collective bargaining agreements were discontinued during the freeze while the participants awaited the announcement of details on Phase Two. Most of the wage increases that were postponed during the freeze are likely to be implemented in the first couple of months after its expiration, along with the wage increases that were previously scheduled to become effective in these months. Depending on how soon after November 13 these raises occur, they will be reflected in the December or January survey results. Even if the guideline of 5.5 percent were to become a ceiling for all of the individual raises, the bunching of increases customarily spread over several months into two months could tend to inflate the size of the wage increase in those two months well beyond the 5.5 percent figure. Thus, the 10.8 percent annual rate of increase that occurred in December in the average hourly earnings of production and nonsupervisory workers in the private nonfarm economy was not unexpected.

The presently available statistics on consumer prices apply to the time period prior to Phase Two. On the basis of revised data, consumer prices climbed 1.7 percent on a seasonally adjusted annual rate basis between August and November, following a 3.8 percent annual rate of increase over the previous eight months of 1971. Including an allowance for the retroactive elimination of the automobile excise tax, which has been signed into law by the President, prices of nonfood consumer commodities are now reported as having been unchanged on a seasonally adjusted basis over the August-November period. While food prices edged up only slightly, most of the advance in the overall consumer price index from August to November was centered in services prices. These prices increased at a nonseasonally adjusted annual rate of 3.1 percent from August to November, significantly less than the rate of increase earlier in the year.