The Business Situation

The latest business indicators provide further confirmation that the domestic economy has expanded vigorously in virtually every sector in recent months. Real gross national product (GNP) surged ahead at a very rapid 8.5 percent annual rate in the fourth quarter, with both consumption and investment spending increasing sizably. Moreover, a recent Department of Commerce survey indicates a further acceleration in business investment in 1973. Industrial production increased strongly in December on the heels of even larger earlier gains. In view of the high rate of new orders for durable manufactured goods and the persistent rise in unfilled orders, further strong advances in output appear likely in the coming months. The unemployment rate declined in January to 5 percent, its lowest point in two and a half years, and further improvement appears likely.

The outlook for prices, on the other hand, is clouded by several factors. The effectiveness of the largely voluntary controls under Phase Three of the Economic Stabilization Program is yet to be tested. Consumer prices advanced only modestly in December, but prices of farm products and processed foods and feeds exploded at the wholesale level and it is likely that these increases will ultimately be passed on to the consumer. The fixed-weight price deflator for total GNP rose at a 3.4 percent annual rate in the fourth quarter. While still moderate, this was a more rapid rise than that experienced over the preceding six months. Recent compensation data suggest that there has been some acceleration in wage increases as well which, together with the large increase in social security taxes effective this year, could exert upward pressure on prices in coming months.

GROSS NATIONAL PRODUCT AND RELATED DEVELOPMENTS

According to preliminary estimates from the Department of Commerce, the market value of the nation's output of goods and services rose $31.8 billion to a seasonally adjusted annual rate of $1,195.8 billion in the fourth quarter of 1972. After adjustment for changes in the price level, real GNP expanded at a sharp 8.5 percent annual rate. Since the last quarter of 1971, real output advanced at an extremely rapid 7.7 percent rate, the fastest four-quarter increase in more than six years (see Chart I).

Tentative and incomplete data indicate that the advance in the rate of inventory spending contributed $2 billion to the growth of GNP in the fourth quarter (see Chart II), as inventory accumulation reached a $10 billion annual rate, its highest in five years. Notwithstanding this marked pickup in inventory spending, the ratio of inventories to sales for all business continued to fall in November, the latest month for which data are available, suggesting that further strengthening in this area may be in the offing.

The fourth-quarter rise in current-dollar final expenditures—GNP net of inventory accumulation—amounted to a substantial $29.8 billion, an annual rate of increase of over 10 percent. Among the components of final expenditures, consumer purchases and business fixed investment spending were particularly robust. State and local government purchases of goods and services also contributed strongly to boosting final demand.

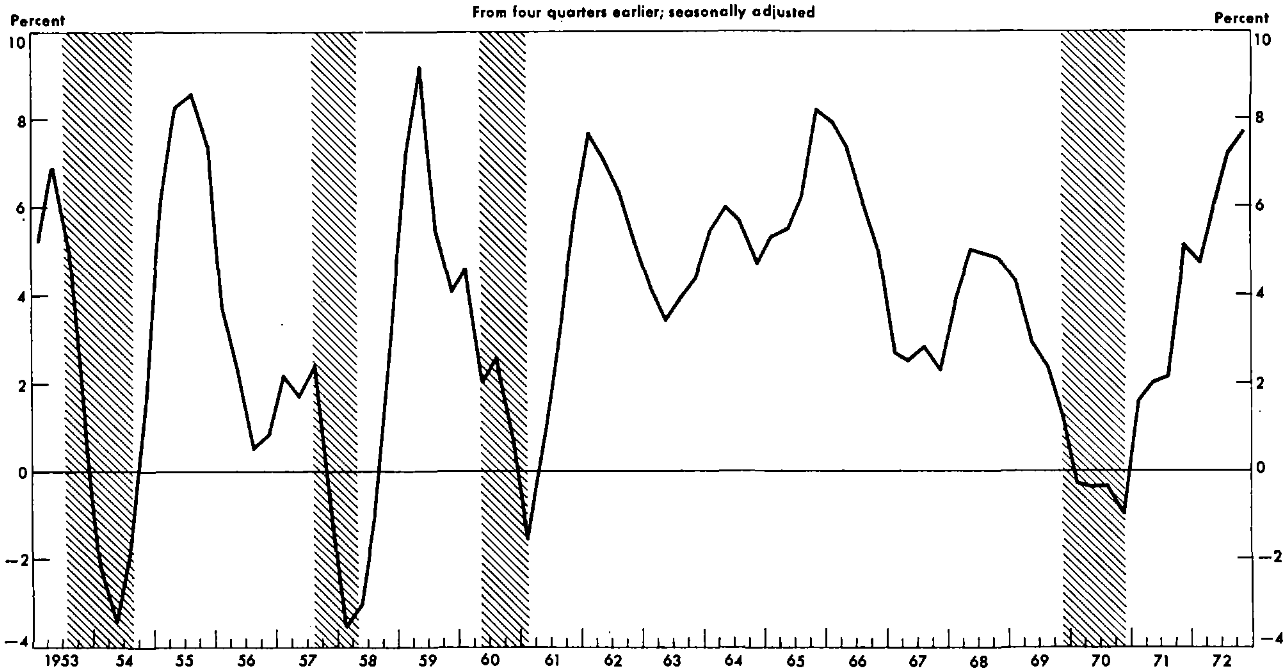
Personal consumption expenditures rose by a substantial $17.6 billion during the fourth quarter. The more than 9.5 percent growth of consumption over the year had not been matched since 1968. Outlays for nondurable goods and services posted strong gains in the final quarter, while the gain in durable goods spending moderated somewhat as the increase in unit sales of domestic and imported automobiles was less ebullient than during the July-September period.

The vigorous fourth-quarter expansion in consumer spending was accompanied by an unusually large $34.4 billion increase in personal income. However, the fourth-quarter jump stemmed in part from several nonrecurring factors, including the 20 percent increase in social security benefits which became effective in October and the substantial addition to railroad retirement and veterans' educational benefits in November. But, even if all trans-

Chart I

PERCENTAGE CHANGES IN REAL GROSS NATIONAL PRODUCT

From four quarters earlier; seasonally adjusted



Note: Shaded areas represent recession periods, according to the National Bureau of Economic Research chronology.
The dates of the 1969-70 recession are tentative.
Source: United States Department of Commerce, Bureau of Economic Analysis.

fer payments are excluded from the third- and fourth-quarter totals for 1972, personal income still grew by a rapid $23.6 billion in the final quarter. Increases in wage and salary payments remained the cornerstone of this advance as a result of further gains in employment, earnings, and hours. Farm income also expanded rapidly in the last two months of 1972. The rate of savings out of disposable income jumped from 6.4 percent in the third quarter to 7.5 percent, thus reversing the generally lower trend shown by the savings rate earlier this year. Probably the fourth-quarter rise reflected the unusually large size of the increase in disposable income, since consumers generally seem to require some time to adjust consumption patterns to sudden advances in income. Nevertheless, because of the substantial tax refunds expected in the first half of 1973 as a result of the overwithholding of personal income taxes last year, the savings rate may well remain close to this level or climb somewhat further in the quarters immediately ahead.

Business fixed investment grew by $4.9 billion in the fourth quarter, with the gain divided between expenditures for producers' durable equipment and structures. Over 1972, such investment spending expanded at nearly a 14½ percent rate, compared with the 11½ percent increase recorded in 1971. Rising new orders for nondefense capital goods equipment point to continued strength in investment. In addition, the Federal Reserve Board's index of capacity utilization for the fourth quarter of 1972 reached its highest mark since early 1970. The latest Commerce Department survey indicates that intended outlays for plant and equipment (which does not include certain types of fixed investment such as trucks and buses) are expected to rise in 1973 by almost 13 percent, somewhat more than had been indicated by earlier surveys and substantially above the 9 percent increase posted for 1972. In particular, the Commerce survey suggests a 13½ percent rise in capital outlays in manufacturing industries and a 12½ percent advance in other sectors.

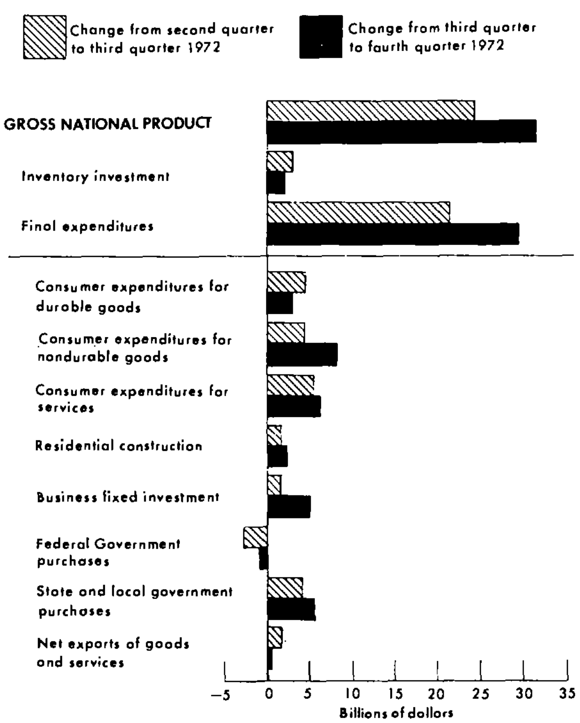
Residential construction expenditures increased by $2.4 billion in the October-December period, capping a strong year for home building. On a seasonally adjusted basis, home-building outlays were 20 percent greater in the fourth quarter than they had been a year earlier and were almost double their recession low of the second quarter of 1970. Underpinning this persistent strength, the pace of housing starts remained rapid during the last months of 1972. In addition, the number of newly issued building permits granted reached a record peak in December.

Expenditures of state and local governments climbed by a substantial $5.6 billion in the fourth quarter, primarily reflecting the stepped-up pace of their construction activity. With the enactment of revenue sharing and the favorable budget position of many states and localities, further sizable gains in spending may be in the offing. On the other hand, Federal purchases of goods and services declined by $0.9 billion in the fourth quarter, attributable to a $0.7 billion slowdown in defense spending following the even more substantial $3.5 billion third-quarter reduction.

Chart II

RECENT CHANGES IN GROSS NATIONAL PRODUCT AND ITS COMPONENTS

Seasonally adjusted



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

PRICE DEVELOPMENTS

While inflationary pressures for most goods and services appeared to subside somewhat during Phase Two, the outlook for additional improvement on the price front is uncertain. The persistent and extraordinarily rapid run-up in prices of farm products and processed foods and feeds at the wholesale level is disturbing and should have an adverse impact on consumer food prices in early 1973. The liberalization of wage and price controls effected in Phase Three of the Economic Stabilization Program has added to the uncertainty. Adherence to the wage and price guidelines was made largely voluntary except in the food, health, and construction industries where controls remain mandatory. In addition, rent controls were abolished and the profit margin guidelines were liberalized somewhat. It is certainly too early to tell how this new strategy will affect prices in 1973, although some immediate bulge may materialize as some firms implement price increases that had previously been awaiting the approval of the Price Commission.

With the notable exception of food prices, the pace of inflation appears to have changed little in recent months. According to preliminary estimates, the implicit price deflator for total GNP advanced at a 2.7 percent annual rate in the fourth quarter, slightly above the 2.4 percent third-quarter increase. By the end of 1972, the GNP deflator had risen only 3 percent from four quarters earlier, its slowest pace in seven years. However, the implicit price deflator is affected by shifts in the composition of output toward either lower or higher priced goods. The fixed-weight deflator computed by the Department of Commerce corrects for this problem as it is based on the composition of real output in 1967. This fixed-weight price index showed an increase of over 3.9 percent during 1972. For the fourth quarter as well, the fixed-weight deflator rose more rapidly than the implicit GNP deflator.

Wholesale prices rose at a sharp 9.6 percent seasonally adjusted annual rate from September to December. This rapid increase was the result of an extraordinary rise in agricultural prices; by comparison, increases in wholesale industrial commodity prices have been moderate, rising only 2 percent over the quarter. Prices of farm products and processed foods and feed increased sharply in November and soared in December, climbing by 5.2 percent seasonally adjusted in that month alone. Of course, this gain is likely to be reflected in months to come in consumer food prices. The December surge in wholesale food and feed prices stemmed from large increases in prices of grains, oil seeds, and manufactured animal feeds as well as continued increases in egg and livestock prices. Heavy domestic and foreign demand underlies the strong upward movement in food and feed prices apparent since last spring. In particular, sales of wheat to the Soviet Union in 1972 accounted for about one fourth of the domestic wheat harvest. In addition, on the supply side, bad weather affected the harvesting of many crops in recent months. A number of steps have been taken to increase the supply of farm and food products. Among these are the elimination of meat import quotas and the increase in the allowable acreage for planting and grazing under Federal farm subsidy programs.

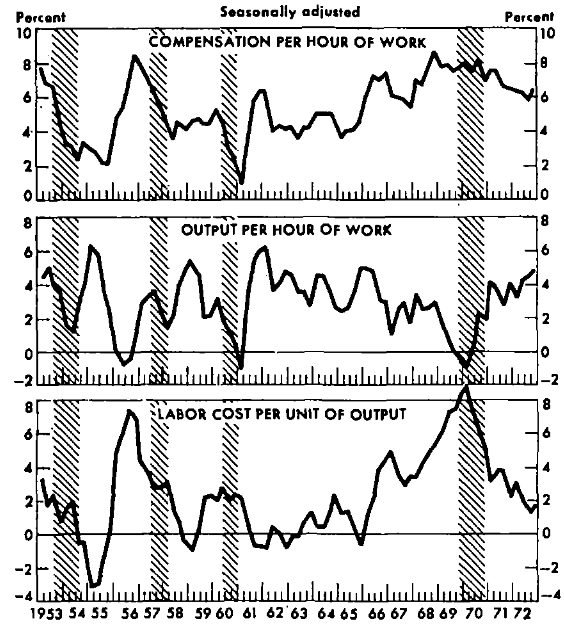
Consumer prices rose at an annual rate of only 2.6 percent in December, but prices of nonfood commodities and services showed gains somewhat above the monthly average for 1972. Over the last three months of 1972 consumer prices increased at an annual rate of 3.2 percent, bringing the increase for the year as a whole to 3.5 percent. During the fourth quarter, nonfood commodity prices increased at an annual rate of only 1 percent but food prices posted a rapid 5.2 percent rate of advance, largely because of a substantial jump in November. Somewhat surprisingly, seasonally adjusted food prices held steady in December, as declines in beef prices offset increases for eggs, cereals, and bakery products. At the same time, prices for services climbed at a 4.5 percent annual rate, a more rapid advance than that experienced overall in 1972.

Chart III

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

CHANGE FROM FOUR QUARTERS EARLIER

Seasonally adjusted



Note: Shaded areas represent recession periods, according to the National Bureau of Economic Research chronology.

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

WAGES, PRODUCTIVITY, AND EMPLOYMENT

During the fourth quarter, compensation per hour of work in the private economy increased at a 7.8 percent seasonally adjusted annual rate, compared with the 4.3 percent rate of increase posted in the previous three-month period. Despite this acceleration, a fundamental slowing in the rate of increase in compensation is apparent over the eight quarters since the cyclical trough at the end of 1970 (see Chart III). It is, however, uncertain that this improvement can be extended. Compensation per hour of work in the private nonfarm economy, which excludes the sometimes volatile farm sector, also posted a faster increase in the fourth quarter than in the third. Preliminary data indicate that average hourly earnings adjusted for interindustry shifts in employment and for overtime in manufacturing rose less rapidly in January than in the last quarter of 1972.

During the final three months of 1972, increases in wages and benefits under collective bargaining agreements covering 5,000 or more workers moderated further, thus continuing the improvement evident earlier in the year. For 1972 as a whole, first-year wage and fringe benefit increases averaged 8.4 percent, a significant slowing from the gain of around 13 percent for the preceding year. At the same time, however, contract duration decreased somewhat in 1972, as unions seemed reluctant to commit themselves to long-term settlements under Phase Two. Furthermore, new settlements covering some 900,000 workers were not included in the 1972 bargaining data since they had not received Pay Board approval at the end of the year. In any event, the collective bargaining schedule for 1973 is heavy, and further moderation in this area is essential if cost pressures are to be restrained.

Productivity, as measured by output per hour of work in the private economy, increased over the October-December interval at a 5.4 percent annual rate, up considerably from the pace of the previous quarter primarily because of a sharp improvement in the agricultural sector. Nevertheless, the 4.9 percent increase in productivity over the four quarters of 1972 was faster than in any year since 1965. As in previous periods of rapid economic expansion, the advance in unit labor costs has slowed considerably. Although fourth-quarter data indicate an expansion in unit labor costs at a 2.6 percent seasonally adjusted annual rate, over 1972 as a whole such costs rose only 1.7 percent. In contrast, unit labor costs climbed at rates of between 3.5 percent and 8.3 percent during 1966 through 1970 and at a 2.2 percent pace in 1971.

According to the monthly survey of households, the civilian labor force and employment declined in January after adjustment for seasonal variation. Much of the decline in employment took place in the agricultural sector. At the same time, the unemployment rate dipped to 5 percent from the downward revised 5.1 percent rate now reported for December. This brought the rate of unemployment to its lowest level since July 1970. The household series was revised back to 1967 as part of the annual updating of seasonal adjustment factors. Unemployment rates for most major groupings in January were similar to those posted in December, although the rates for workers under twenty-five years of age showed sizable declines. The January survey of establishments indicated a continued rise in nonfarm payroll employment in that month, with gains widespread among industries. (Discrepancies in the movement of the household and payroll series occur because of different survey coverage and seasonal adjustment techniques.) Based on preliminary data, sizable declines were posted in the average workweek in the manufacturing sector and the private economy as a whole in January, and overtime in manufacturing also fell for the first time in seven months. However, these data may be subject to some revision when the total payroll sample becomes available.