The Business Situation

The slowdown in economic activity in the first quarter of 1970 was reflected in both a decline in real GNP and an increase in unemployment. At the same time, price and cost pressures continued to be severe. Toward the end of the quarter, there were some tentative signs of a bottoming-out in economic activity and of a slight moderation in price pressures. Industrial production increased in March for the first time since last July, and housing starts posted a second successive monthly gain. At the same time, price increases at the wholesale level showed some signs of lessening in March and April.

More broadly, the economic outlook remains quite strong despite a number of uncertainties, including the recent sharp drop in the stock market and developments in Indochina. In April the pay increase for Federal employees and the boost in social security payments began to add to spendable income, and the income tax surcharge is due to expire at the end of June. Moreover, recent surveys continue to suggest that a sizable growth in capital spending is likely. The underlying strength of the economy and the prospect of continued large wage settlements point to the need for persistence in the fight against inflation.

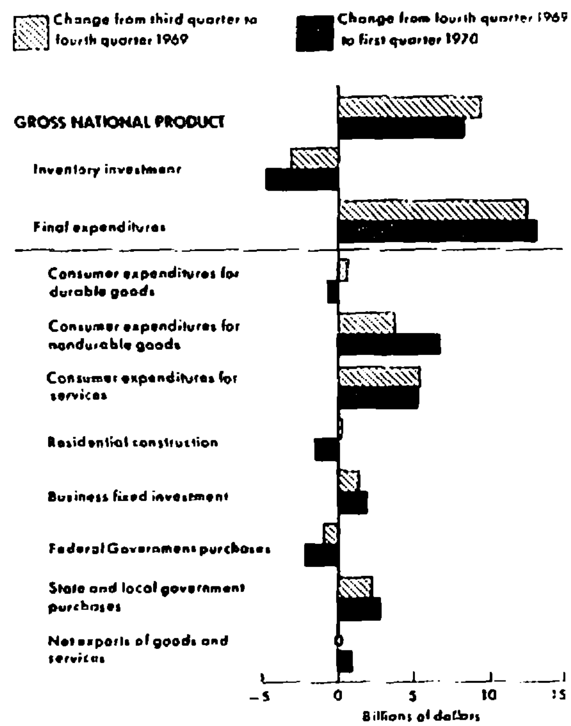
GROSS NATIONAL PRODUCT

The nation's total output of goods and services, according to preliminary estimates, declined again in the first quarter of 1970, after allowing for the continued sharp increase in prices. Real gross national product (GNP) fell at an annual rate of 1.6 percent, following the previous quarter's fractional decline. Despite this further slowing in real GNP, the implicit price deflator accelerated slightly from a 4.7 percent rate of growth in the final quarter of last year to the first quarter's rate of 5.0 percent. While this information scarcely constitutes evidence that inflation has worsened, it does cast doubt on the view that prices are beginning to respond favorably to moderating demand. Expressed in current prices, GNP continued to expand, but the gain of $8.2 billion (see Chart I) was the smallest since the first quarter of 1967. As in the fourth quarter of last year, the expansion in current-dollar GNP was depressed by a sharp drop in inventory accumulation. Final demand, that is, GNP less inventory change, actually rose by a slightly larger amount in the first quarter than in the October-December period. The first-quarter increase in final demand was centered in consumer spending for nondurable goods, in business fixed investment, and in state and local government purchases.

The inventory component exerted a $4.8 billion drag on the expansion of GNP. A slowdown in inventory spending can reflect either deliberate efforts to correct for excesses in stocks or an unexpected bulge in sales. In the first quarter, the former appears to be a more plausible explanation for most of the behavior of inventories. The business inventory data for January and February, on which these preliminary inventory estimates are based, indicate that firms in the durable goods sector at both the manufacturing and trade levels have attempted to correct the imbalances that developed near the end of 1969. This behavior has been particularly evident in the automobile industry, where the stock of unsold cars has been reduced substantially since late last year. On the other hand, consumer spending on nondurable goods showed such strength that some of the slowdown in inventory accumulation may have reflected unexpectedly strong sales.

The reduction of the income tax surcharge from 10 percent to 5 percent at the beginning of 1970 contributed substantially to the first-quarter gain in disposable personal income. While the first-quarter rise in pretax income was only $0.2 billion more than that for the preceding quarter, spendable income rose by $3.9 billion more in the first quarter of 1970 than in the previous quarter. The first-quarter gain in disposable income was

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



Source: United States Department of Commerce.

accompanied by a fairly large increase in personal consumption expenditures, and the saving rate changed very little. The boost in consumer spending reflected the largest increase in expenditures on nondurable goods since the first quarter of 1968. Spending on services continued to expand at much the same rate as in recent quarters, but expenditures for durable goods declined slightly. Much of the weakness in durables can be seen in unit auto sales, which dropped from a seasonally adjusted annual rate of 8.1 million units in the final three months of 1969 to a 7.4 million unit pace in the first three months of this year. The poorest sales performance occurred in January, however, when dealer deliveries were at a 6.8 million unit rate. Auto sales recovered strongly in February to a 7.9 million unit rate, then fell back in March to a 7.4 million unit pace. In April the sales pace was a little better than the previous month's rate.

Investment in plant and equipment continues to expand, in agreement with the surveys of business capital spending intentions. Most of the first-quarter increment resulted from a fairly sizable rise in spending on structures. The unusually small increase in expenditures on equipment probably reflected the General Electric strike. Recent survey findings and actual spending results have yet to show the cutbacks that might normally be expected in light of falling profits, plant operating rates substantially below preferred levels, and tight credit conditions; apparently, efforts to check the steep climb in labor costs continue to outweigh such inhibiting factors. The McGraw-Hill spring survey indicated a 9 percent increase in 1970 expenditures on plant and equipment. Although this represents a slightly smaller gain than the Department of Commerce-Securities and Exchange Commission survey had indicated earlier in the year, the 9 percent boost exceeds, though narrowly, that which had been suggested by the fall McGraw-Hill survey. Upward revision of spending plans by nonmanufacturing firms has tended to offset some cancellations or deferrals by manufacturers.

Spending on residential structures declined in the initial quarter of 1970 and remained substantially below the high attained at the outset of 1969. Housing starts were also down for the quarter, but the rate moved up from the very low January figure with some vigor in the latter two months of the period. Despite the February and March advances in starts, the near-term outlook for home building appears considerably short of buoyant. The rate of starts is still substantially below the pace recorded in early 1969 and the rate of permits issued for new homes fell off in March, though this series has been unusually wobbly of late. The availability of funds for mortgages has shown some slight improvement in recent months, but land, labor, and financing costs continue to soar, pushing the price of homes beyond the means of a growing proportion of young families.

The increase in state and local government spending was larger in the first quarter than in either of the preceding two quarters, although these governments continue to experience financing difficulties. Federal Government expenditures dropped by $2.1 billion in the first quarter, the largest decline since the spring of 1954; a cutback in defense outlays accounted for most of the fall. Upward pressures in expenditure programs continue to accumulate, however, and the Federal employees' pay increase, retroactive to December 27, will also contribute to higher Federal spending.

The remaining GNP component, net exports, added $1.0 billion to the expansion in total spending. In recent quarters, the growth in exports of goods and services has exceeded that for imports; first-quarter net exports were at the highest level since late in 1967.

INDUSTRIAL PRODUCTION

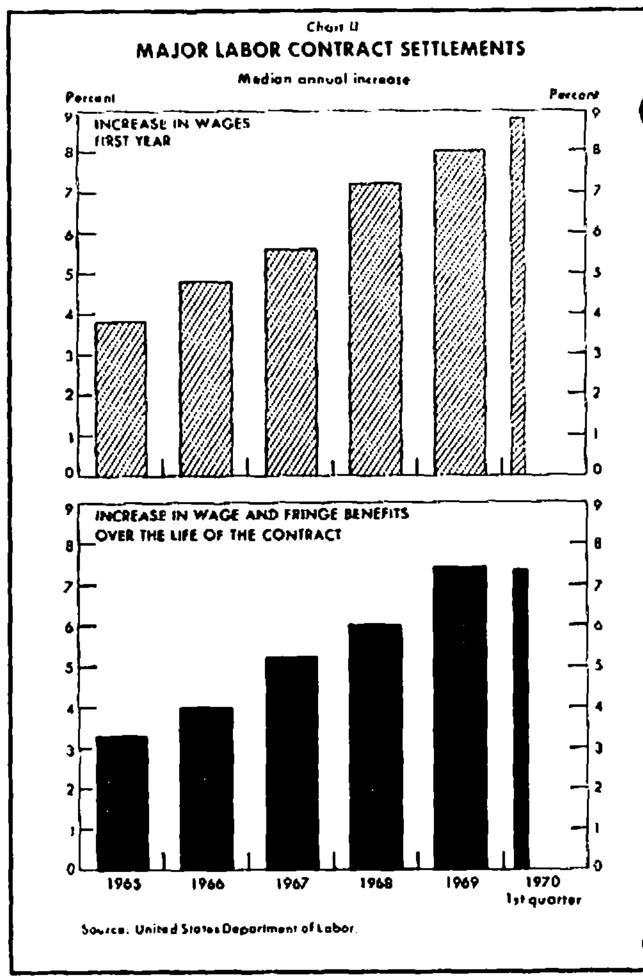
Like real GNP, industrial production was lower in the first quarter of this year than in the final quarter of 1969, but the monthly data on industrial output showed a slight rise in March following a small decline in February and a sizable drop in January. This pattern raises the possibility that production, after a seven-month downward drift in the overall index, may be regaining some strength. The decline in output from last July to this February was gradual, and never developed into the widespread, sharp cutbacks in production that have been associated with post-World War II recessions. The total decline in the July-February period was 2.7 percent, exceeding narrowly the 2.4 percent drop in the index that had occurred during the mini-recession of early 1967. Subsequent to similar extended periods of decline, a one-month rise has usually been followed shortly by an upswing. The March figures, however, are still preliminary, and past experience, of course, need not be repeated.

Although the resumption of operations at General Electric plants, following a long strike, contributed positively to the production index in March as well as in February, the March rise in the index reflected mainly sizable gains in the automotive products and steel components, two industries that are highly sensitive to cyclical fluctuations in demand. Iron and steel production rose 2.4 percent in March, the largest gain since last June, and the raw steel output figures suggest another increase in April. As long as the export demand for steel products remains healthy, as is expected, the near-term outlook for the industry is primarily dependent upon the auto situation.

The output of motor vehicles and parts advanced by 5.6 percent in March, the first increase since last July. The same pattern is evident in the unit figures, as auto production fell from a seasonally adjusted annual rate of 9.1 million units last July to a 6.5 million unit pace in February, then rose to a rate of 7.1 million units in March. As sales have shown some steadiness, inventories have been brought down further in recent months. The stock of unsold cars at 1.4 million units was at the lowest level, on a seasonally adjusted basis, for any month since the summer of 1968 with the exception of July 1969, when dealer inventory holdings were at about the same level. With inventories coming within acceptable limits and the demand for new autos at least holding firmly at recent levels, production schedules for the April-June period indicate that output might continue rising. Nonetheless, actual production in April ran below the planned rate, apparently reflecting plant shutdowns necessitated by striking teamster locals rather than an unexpectedly poor sales performance. In the months immediately ahead, the production figures will no doubt show adjustments in anticipation of a possible strike by auto workers when the contract expires in September.

WAGE AND PRICE DEVELOPMENTS

The slowdown in economic activity has been accompanied by easing in the demand for labor, but labor costs continue to rise steeply, and recent labor contract settlements indicate that these costs will remain a source of intense pressure on prices in coming months. Summary data on major collective bargaining settlements for the 1965-69 period bring into sharp focus the uptrends in first-year wage increases and in the wage-benefit package over the life of the contract (see Chart II). Preliminary first-quarter data for 1970 indicate a further boost in the



first-year wage gain, while the overall wage-benefit increase remained about the same as last year's median. First-quarter agreements covered fewer than 700,000 workers of the approximately five million covered by contracts expiring this year. The relatively small number of workers receiving large first-year wage increases as well as declines in overtime work in some high-wage industries have thus far limited the impact of such settlements on labor compensation per man-hour in the private economy, but the increase has been rapid. Combining the trend in labor compensation with the poor performance of productivity, unit labor costs have been accelerating and rose at an annual rate of 8 percent in the first quarter, the largest advance for any quarter in fourteen years. Sizable first-year wage gains will tend to offset the effects of any improvement in productivity. In the contract negotiations this year, workers are seeking to maintain an increase in real wages and to catch up with other workers who have already obtained generous settlements. As economic activity slows, the easing of pressures in the labor market should tend to reduce the size of union and nonunion wage settlements, and the easing of demand pressures will make it more difficult for firms to pass along additional labor costs through higher prices. Nonetheless, we cannot expect slower economic activity to return the rate of wage increase in the near future to the noninflationary pace of long-term productivity.

Although industrial wholesale prices continue to rise at an excessive rate, there are some indications that the rate of increase may be slowing. According to preliminary data, which have been subject to upward revisions in recent months, industrial commodities prices rose at a 3.1 percent annual rate in April. The April gain was equal to that for March, but it was below the rates recorded in the first two months of the year and the average monthly increase registered last year. In addition, cyclically sensitive materials prices have tended to ease downward in recent months, possibly foreshadowing a further slowing in the industrial commodities component. Agricultural products prices fell in April, causing the overall wholesale price index to fall. The agricultural component often moves erratically, however, and the overall index may thus be of questionable value in discerning the trend in wholesale prices.

Consumer prices rose at a 6.3 percent annual rate in March. The March advance in the index exceeded, though narrowly, the average monthly gain of 6.1 percent recorded through 1969 and was noticeably higher than the 5.5 percent rate of increase registered for the first two months of this year. Reflecting sharp boosts in mortgage charges and medical care costs, the gain in services prices was extraordinarily large, and the cost of nonfood commodities climbed at the fastest pace since last November. On the other hand, a very small rise in food prices softened the advance in the overall index. After adjustment for seasonal variation, the consumer price index still shows no solid evidence of a slowdown in its rate of increase. Even though the adjusted figures indicate a rise of 4.8 percent for March, the rate of gain through the first three months of 1970 on this basis is essentially the same as the average monthly rate in 1969.