The Business Situation

Current business developments suggest a relatively sluggish recovery, but the underlying trend of the economy is obscured by the General Motors strike. Economic activity, as measured by the nation's real output of goods and services, registered a small advance in the third quarter, according to preliminary estimates. This was an improvement in the overall performance of the economy, compared with the previous three quarters. However, in the July-September period, unemployment climbed to 5.2 percent of the labor force, up from 4.8 percent in the previous quarter and 4.1 percent in the first quarter of 1970, while average hours worked continued to decline. Industrial production was down sharply in September, largely but not exclusively as the result of the automotive situation. August and September retail sales failed to sustain the momentum they seemed to be gathering in previous months, so that the increase in consumer spending over the whole quarter was only moderate. New orders for durable goods declined in September for the second consecutive month. Thus, with the exception of housing starts and building permits, which rose substantially during the third quarter, data for recent months give few indications of vigor.

While some tentative signs of moderation emerged on the price front during the third quarter, recent developments indicate that the persistent problems of inflation are still very much with us. During the third quarter, the price deflator for gross national product (GNP), which is the broadest measure of price changes in the economy, rose at about the same rate as in the second quarter but well below the rapid pace of the first quarter of the year. However, the consumer price index rose sharply in September. Much of the earlier slowing in consumer price increases had been linked to changes in food prices, a rather tenuous basis for improvement. The rate of price increases for wholesale industrial products, which are more central to the inflation problem than changes in agricultural prices, has zigzagged over the past year or so. This makes it difficult to attach much significance to quarterly or monthly changes, but wholesale prices of industrial commodities appeared to accelerate in September and, particularly, October.

Little or no evidence has appeared to indicate any ebbing in the rapidly rising tide of wage increases. Increases negotiated in contractual wage settlements continued to leap ahead during the third quarter, reaching a particularly dizzying pace in the unionized construction sector. Although rising productivity—largely resulting from substantial declines in man-hours associated with the business downturn—has blunted some of the impact of rising compensation on unit labor costs, wage and salary increases are far outstripping productivity gains. This can only serve to make the goal of reasonable price stability all the more difficult to attain.

GROSS NATIONAL PRODUCT

The market value of the nation's total output of goods and services rose $14.1 billion during the third quarter to an annual rate of $985.2 billion, according to preliminary estimates of the Department of Commerce. Since the impact of the General Motors strike was not felt until the latter half of September, it had only a limited effect on the figures for the entire quarter. Nevertheless, in the absence of the strike, the quarterly rise in GNP probably would have been $1 billion to $2 billion larger than the reported increase. Overall economic activity in the coming quarters will certainly be influenced by the length of the strike, the settlement terms, and the manner in which lost production is recouped. The longer the strike, the greater the secondary effects on suppliers of automotive materials and the greater the repercussions from reduced spending by those directly and indirectly idled as a result of the dispute.

Real GNP grew in the third quarter, but only at a very slow 1.4 percent annual rate. To be sure, there was an improvement over the previous three quarters when real output actually fell for six months and then remained about unchanged in the April-June period. Inflation accounted for the major part of the overall GNP advance. The price deflator for total GNP rose at an annual rate of 4.4 percent, which was about the same as the previous quarter's 4.3 percent gain but below the 6.4 percent rise in the first quarter.

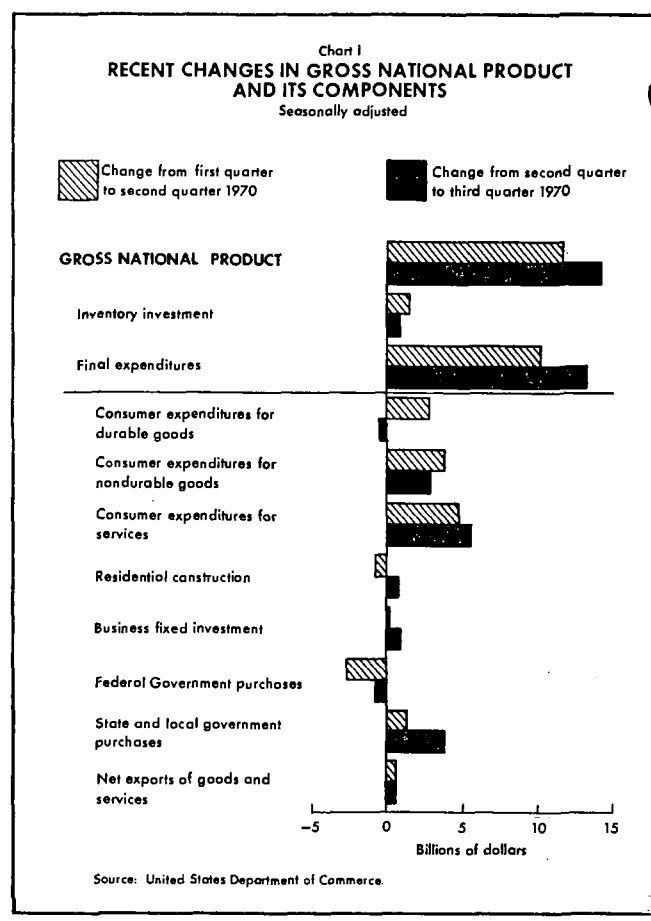
The seasonally adjusted rate of increase in consumer prices slowed to about 4.2 percent during the July-September period. However, the consumer price index jumped ahead sharply in September to an annual rate of 6.4 percent, somewhat higher than the average over the preceding year and a half. The September rebound was most pronounced among prices of nonfood commodities and services, which are more indicative of basic inflationary pressures than are food prices, but the latter also rose on a seasonally adjusted basis.

Recent movements in the wholesale price index have been dictated to a great extent by large, erratic swings in the prices of agricultural commodities. Since short-run movements in farm prices are heavily influenced by forces mainly outside the economic system, e.g., weather and blight, they are, in a sense, not at the core of the current inflationary problem. Prices of industrial wholesale products, on the other hand, are more responsive to changes in overall economic activity. Since monthly and quarterly rates of increase for wholesale industrial prices have a sawtooth appearance when mapped out over the past year or so, trends are difficult to discern. Nonetheless, the swift climb in the seasonally adjusted annual rate of increase from August's low 2 percent to September's 3 percent and, finally, to October's startling 7 percent rise is discouraging. On balance, the extent to which any price improvement can be discerned depends heavily on the indicators and time periods examined. At present, available evidence suggests that inflation remains a serious problem.

The somewhat stronger performance of total GNP in the third quarter was centered in final demand inasmuch as inventory spending remained modest. Both business fixed investment and residential construction were stepped up, the latter development bringing to an end the steady decline that had spanned the previous four quarters. State and local government spending also rebounded in response to improved credit market conditions (see Chart I).

Business spending on inventories contributed $0.9 billion to the third-quarter rise in GNP. While inventory spending imparted a somewhat larger ($1.5 billion) impetus to the growth of GNP during the second quarter of 1970, it had acted as a substantial drag in the two previous quarters. As usual, the preliminary inventory accumulation estimates for the third quarter are based on the developments during the first two months of the quarter. In making its estimate, however, the Commerce Department apparently adjusted for the likelihood that the large stockpiling of July and August in anticipation of the auto strike would not be repeated in September. During July and August, a large part of the advance in the book value of total business inventories took place at retail automotive outlets, leading to a sharp rise in the inventory-sales ratio for these stores. Based on preliminary data for July and August, however, there appears to have been a small decline in the third-quarter inventory-sales ratio for all businesses. No doubt, the automotive situation will continue to exert a considerable influence on inventory adjustments for some time to come.

Personal consumption expenditures rose $8 billion in the third quarter, the smallest gain since the final quarter of 1968. Spending on services was strong, but purchases of nondurable goods rose only slightly and expenditures for durable goods actually declined. These developments are consistent with the course of monthly retail sales, which began the quarter on a strong note in July but lost momentum during August and September. As a result, total third-quarter retail sales, using advance estimates for September, grew at a seasonally adjusted annual rate of only 2.7

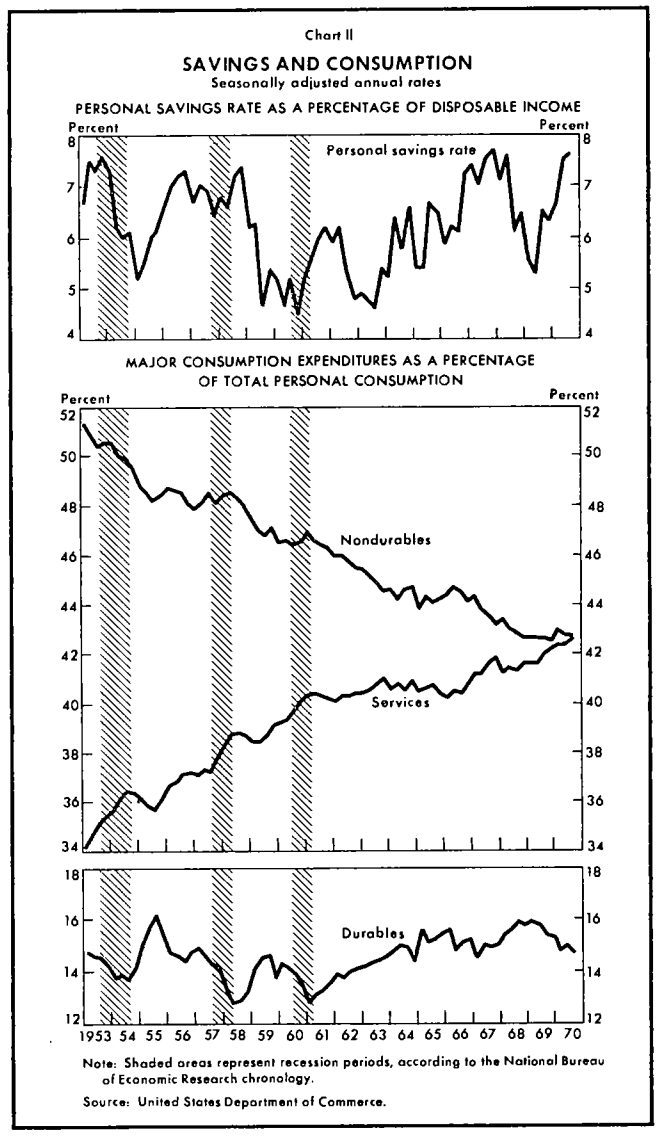


percent in contrast to the 10 percent rate of increase in the previous three months.

In the third quarter the growth of consumption spending was dampened both by the impact of a small increase in disposable, or after-tax, income and by an apparent preference on the part of consumers to save a greater than usual proportion of their incomes. Despite the expiration of the remaining 5 percent income tax surcharge, disposable incomes grew by the smallest amount since the first quarter of last year, as reduced man-hours and declines in payroll employment cut into wage and salary disbursements. The personal savings rate rose to 7.6 percent in the July-September period, which was quite high by historical standards (see Chart II). This unusually large volume of savings probably reflects consumer uncertainty over the outlook for prices and the economy. In addition, a part of the rise in the rate may be attributable to a normal lag in the adjustment of spending to the expiration of the income tax surcharge. The accumulated savings could provide fuel for a stronger pace of consumer spending in future months.

Spending on consumer services rose by $5.5 billion in line with the strong long-run growth trend of such consumption. Indeed, services have accounted for a larger and larger share of total consumer expenditures. Spending for services is currently 43 percent of consumption, compared with 35 percent in 1953 (see Chart II). All of this growth has been at the expense of nondurable goods, and the share accounted for by durable purchases—though varying over the business cycle—has been unchanged on balance. An important result of this shift is that more and more consumer outlays have been in areas where price increases have been the steepest. Productivity gains are particularly hard to achieve in the service industries, where consumer prices have risen at a 4 percent annual rate in the past decade, compared with a 2½ percent rate of increase in nondurable commodities.

After having declined a total of $5.5 billion since the second quarter of 1969, the dollar volume of residential construction rose by $0.7 billion during the third quarter—a rather modest but nonetheless encouraging increase. This pickup in the dollar volume of home-building activity was small by comparison with the upsurge in housing starts, which rose in the third quarter to the highest rate since the April-June period of last year. However, several factors seem to explain this difference. In terms of expenditures as recorded in the GNP accounts, a substantial part of the outlays associated with third-quarter housing starts will show up in subsequent quarters. In addition, there is some evidence suggesting that third-quarter construction was weighted more toward dwellings with lower value per unit, which partly reflected the fact that a somewhat higher proportion of multifamily structures was started than was the case in the preceding period. Also, the median selling price of new homes during the first two months of the third quarter was actually less than the selling price during the previous quarter and for all of 1969. It should be noted that, in addition to changes in selling prices of new homes having identical characteristics, variations over time in selling prices may also reflect shifts in geographic location and the proportion of homes of different size.



Business fixed investment added $0.9 billion to the third-quarter increase in GNP, according to the still preliminary estimate. Although on the weak side, this was somewhat ahead of the contribution made during the first half of the year. Spending on fixed investment has held up surprisingly well in the face of declining corporate profits and considerable excess capacity. By the third quarter of this year, the rate of manufacturing capacity utilization as measured by the Federal Reserve Board had fallen to 76 percent, the lowest since the first quarter of 1961. Output as a percentage of capacity has tended to decline fairly steadily since 1966 when it averaged 90.5 percent. Recent levels of new orders for producers' durable goods provide little evidence of current or impending buoyancy with respect to equipment spending. Were it not for the large September gain which appears primarily associated with increased shipbuilding bookings, third-quarter new orders for producers' durables would have been little changed from the first half of the year.

The total government sector contributed $2.9 billion to the third-quarter gain in GNP, with an increase in state and local government outlays more than offsetting a small net decline in Federal purchases. The latter reduction was associated with a cutback in defense spending which was only partly counterbalanced by a limited rise in nondefense purchases. Defense expenditures were off nearly 6 percent in the third quarter from the high reached in the third quarter of 1969. State and local government purchases of goods and services benefited from improved credit market conditions and grew by $3.7 billion.

PRODUCTION, PRODUCTIVITY, AND WAGES

The Federal Reserve Board's seasonally adjusted index of industrial production dropped 2.9 percentage points (1.7 percent) in September to a level nearly 5 percent below the July 1969 peak (see Chart III). About two thirds of the September decline was linked to the direct and indirect effects of the work stoppage at General Motors. Auto assemblies in September were at a seasonally adjusted annual rate of 5.7 million units, off fully one third from the previous month. The impact of the automotive dispute on the October index is likely to be in the range of 1 to 2 additional percentage points, but overall industrial production, of course, will also depend on output in sectors beyond the immediate influence of the strike.

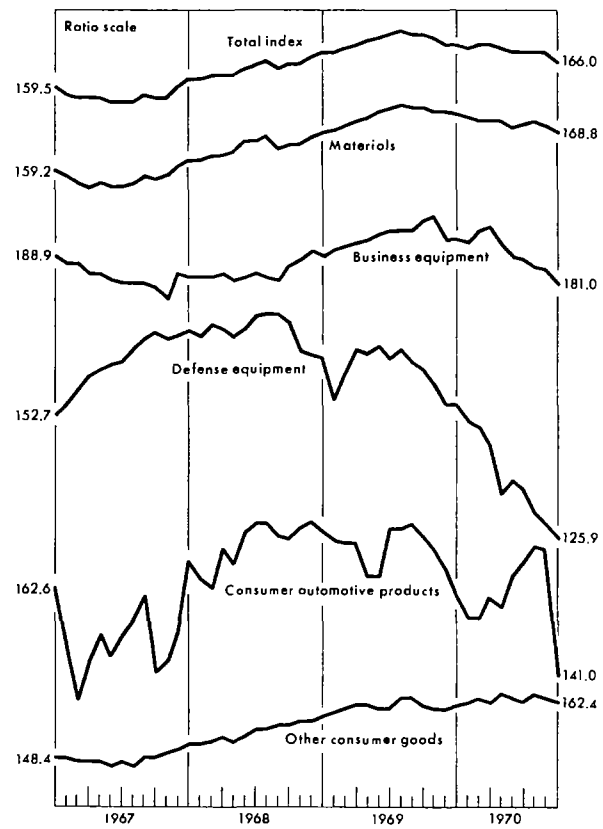
Among the major industry groupings, only mining, which benefited from a greater volume of fuel output, and utility production rose during September. Production by manufacturers of nondurables fell to the lowest level since January of last year. Equipment output continued the pronounced decline begun during October 1969, the result of further cutbacks in both the defense and business equipment sectors.

Compensation per man-hour in the total private economy rose at a swift 7.6 percent annual rate during the third quarter, the fastest this year. At the same time, the rather hectic pace of collective bargaining settlements showed few signs of abating. Over the first nine months of this year, the mean first-year wage and benefit settlement for collective bargaining agreements covering 5,000 or more workers was 14.7 percent, compared with the 10.9 percent rise over all of 1969. Mean increases for the full life of the contracts negotiated were 10.0 percent in the

Chart III

INDUSTRIAL PRODUCTION

Seasonally adjusted; 1957-59=100



Note: Indexes for defense equipment and nonautomotive consumer goods were calculated at the Federal Reserve Bank of New York from data published by the Board of Governors of the Federal Reserve System. Indexes are not plotted in rank order. Data for latest four months are subject to revision.

Source: Board of Governors of the Federal Reserve System.

first three quarters of this year as against 8.2 percent during all of last year.

Wage gains as a whole, and especially those in the unionized areas of the economy, have continued to outstrip productivity increases. Output per man-hour in the private economy, one measure of productivity, rose at a substantial 4.6 percent annual rate. This advance, however, was clearly associated with the business cycle since it stemmed from the combination of a small increase in output and a rather large decline in man-hours. These gains are distinct from those of a more permanent nature, resulting from such factors as innovation, increased use of capital, and a more educated labor force. Taken together, the output per man-hour and compensation movements indicated a third-quarter rise of 3.0 percent in labor costs per unit of output, perhaps giving some indication of pressures on price and cost levels. Although larger than the 1.5 percent increase in the preceding three months, this was a considerable improvement over the record of other quarters in 1969 and 1970. In these earlier intervals, the average advance in unit labor costs was well above a 7 percent annual rate while productivity gains were small and, in three of the five quarters, negative. In the manufacturing sector, compensation per man-hour rose at about the same rate as in the total private economy, but a much smaller rise in productivity led to a 6 percent increase in unit labor costs during the third quarter. On the whole, these third-quarter developments give little room for optimism. Unit labor costs were still rising at a rapid rate while compensation has continued, if not accelerated, its swift advance. This, coupled with the fact that productivity gains of the order of magnitude recorded in the period cannot be permanently maintained, tends to add a pessimistic note to the price-cost situation over the coming months.