The Business Situation

In the opening months of 1971 many business indicators have moved upward, as stepped-up activity in the automobile industry was reflected in higher levels of production, income, orders, and sales. However, since much —but not all—of these gains in economic activity are strike related, there has as yet been little evidence of a significant underlying strengthening in the economy. In fact, in January, industrial production and manufacturing payroll employment were below the levels that had prevailed at the outset of the General Motors strike. In part, this is a reflection of the relatively slow pace at which automobile production has been resumed after the work stoppage. While interpretation of recent inventory data is complicated by the strike and its aftermath, the most recent information suggests that stocks in some sectors are a bit on the high side in relation to sales quite apart from any strike-induced distortions. The likelihood of substantial stockpiling of steel mill products in anticipation of a midsummer steel strike will probably push inventories higher in the coming months.

The behavior of wages continues to be inflationary. During the fourth quarter of 1970 and for the year as a whole, compensation per man-hour in the private economy rose at a rate only a trifle below the rapid expansion experienced in the preceding year. The value of newly negotiated wage settlements continues to surge ahead at an essentially unabated rate, providing wage increases far in excess of any conceivable long-run gains in productivity. Moreover, the magnitude of the wage gains embodied in these contracts may be understated, since the contracts frequently provide cost-of-living adjustments which are not fully reflected in the reported data. Recent price developments have been somewhat mixed, in part because of volatile movements in the agricultural and food components of both the consumer and wholesale price indexes. However, in January the rate of increase in nonfood commodity prices moderated at the consumer level, and preliminary data for February suggest a slowing of wholesale industrial prices. While both of these developments are encouraging, one- or two-month slowdowns in these price indexes have materialized in the past only to be quickly reversed.

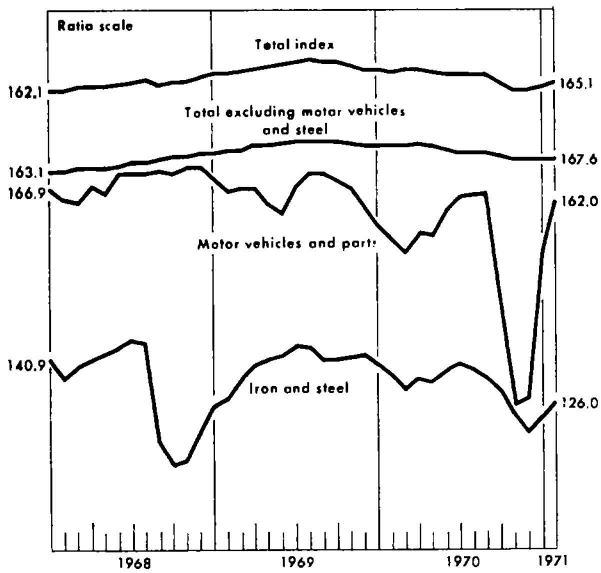
PRODUCTION, SHIPMENTS, AND INVENTORIES

The Federal Reserve Board's index of industrial production increased in January for the second consecutive month. The index rose by 0.7 percent on a seasonally adjusted basis, with higher output of automobiles and steel accounting for all of the gain. At a level of 165.1 percent of the 1957-59 base, the index in January was about 2 percent below its position last August—the month prior to the GM strike—and was about 5.4 percent below the peak attained in July 1969 (see Chart I). The failure of the index to regain its pre-strike level in January suggests that the fourth-quarter slump in business activity extended beyond the depressing influence of the automotive strike. In part, this development is also attributable to the relatively slow pace at which automobile output has been resumed following the termination of the strike. For example, January automobile production ran at a seasonally adjusted annual rate of 8.3 million units, about 0.2 million units below the production rates recorded in July and August of 1970, thus suggesting little or no catch-up production as of that point. Production data for February, however, indicate that automobile output reached about 9 million units, the largest volume since mid-1969.

Aside from the upward movement in production stemming from higher automobile output—and the partially related gain in steel production—industrial activity showed little change in January (see Chart I). In fact, the total production index excluding the steel and automotive components posted a small decline on a seasonally adjusted basis. Once again, a factor in this turn of events was a further drop in the production of equipment.

In January, manufacturers' sales posted a relatively large gain of $1.1 billion following an impressive rise in December that has been revised upward to $1.8 billion. Much, but not all, of this recent strength reflects higher levels of activity in the motor vehicles and parts industry group which, of course, is a result of strike-recovery activity. However, the January data in particular suggest that the rise in sales was not confined to the automobile and related industries. For example, shipments at manu-

Chart I
INDUSTRIAL PRODUCTION
Seasonally adjusted; 1957-59 = 100



Note: 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.

facturers' durables exclusive of motor vehicles and parts rose by $0.4 billion, and sales by nondurables firms rose by $0.3 billion. Despite these gains, however, January sales at durables manufacturers excluding the auto group were still below the volume which prevailed in the August-September period of last year.

Concurrent with the fairly large gain of $1.1 billion in total manufacturers' sales, inventories fell by $0.4 billion in January. Thus, the inventory-sales ratio for all manufacturers dropped to 1.74, about the level which prevailed prior to the auto strike. Much of the decline in inventories reflected a $0.3 billion runoff in stocks at durables manufacturers exclusive of automobile and parts. Accordingly, the inventory-sales ratio for these firms declined from its very high fourth-quarter level. Nevertheless, at 2.30, this ratio is still on the high side by comparison with the experience of the last year and a half.

In January, new orders for durable goods rose by about $1.2 billion, a gain of about 4 percent from the December level. Much of this increase in orders reflected higher bookings for automobiles and steel mill products. Excluding autos and steel, durables orders rose by $0.5 billion or by about 2 percent. At their January levels, orders in the durables industries excluding autos and steel were about 2½ percent above the fourth-quarter average, with the gain spread out among several industry groupings. On balance, the orders situation in January appears to have improved somewhat from recent experience.

RESIDENTIAL CONSTRUCTION ACTIVITY

In January the number of new private housing starts fell by about 16 percent from the December seasonally adjusted rate of 2.0 million units annually. However, at 1.7 million units, January starts were still 17 percent above the average level recorded in 1970. There are reasons to believe that the December figure and thus the January decline were exaggerated by special factors. For example, on a nonseasonally adjusted basis, 54 percent of the December starts were financed by the Federal Housing Administration, up from 28 percent a year earlier. Thus, it may be that the early-December reduction in the FHA mortgage rate caused a one-shot surge in starts. The fact that the fraction of FHA-financed starts dropped back to a more normal 30 percent in January lends credence to this view. There is also the possibility that the recent volatility in housing starts has been exaggerated by seasonal adjustment problems since the seasonal factors for construction activity are always tenuous in the winter months. Along with the fall in housing starts, building permits also declined from their December high. However, here too, the January level of permits was a full 20 percent above the average number of permits issued in 1970 as a whole. In short, indications remain strong that the residential construction sector will be a source of considerable economic strength in 1971.

PERSONAL INCOME AND CONSUMER DEMAND

Personal income posted a relatively large gain of $7.9 billion at a seasonally adjusted annual rate in January. While part of this increase can be traced to special factors, the rise in income exclusive of these nonrecurring elements was about $2 billion more than the average monthly increment in total personal income recorded in 1970. The major factor accounting for the January strength was a $6.8 billion increase in wage and salary disbursements, part of which was attributable to higher payroll employment in January. About a $2.2 billion salary boost for Federal Government employees also contributed to the rise in wage and salary payments. Partly offsetting these gains was a $1.8 billion increase in employee social security tax payments, which are treated as a reduction in personal income. With the exception of dividend payments, which posted a large $1.8 billion rise, the other components of personal income showed little change. The January gain in dividends was simply a reflection of the fact that the December level of these payments was unusually low because of the failure of a number of companies to pay customary year-end extra dividends.

On the basis of advance information, retail sales posted a 1.1 percent gain in January. This increase followed a rise of almost 1 percent in retail volume in December. In both months, higher sales of durable goods accounted for virtually all of the increment in total retail activity. In turn, stepped-up automobile sales have been a major factor in the recent strengthening of durables purchases. Nevertheless, at their January level, retail durables sales were still below the volume that prevailed in September, the last month in which these data were reasonably free of strike-induced distortions. This would suggest that consumer spending decisions are still being tempered by higher prices, high unemployment, and general economic uncertainties.

LABOR COSTS, PRODUCTIVITY, AND PRICES

The fourth-quarter data on compensation per man-hour, productivity, and unit labor costs were severely distorted by the effects of the GM strike. However, even allowing for this factor, the evidence remains strong that rising wage costs have shown little reaction to the marked increase in unemployment which emerged during 1970. During the final three months of last year, compensation per man-hour in the private economy rose at a seasonally adjusted annual rate of about 6.4 percent, down from the 7.5 percent increase registered in the previous quarter. However, indications are that most—if not all—of this slowing reflected a shift in the composition of employment away from the high-wage industries, which were most affected by the automobile strike, and the concurrent fall in overtime hours worked. For 1970 as a whole, the rise in compensation per man-hour equaled 6.6 percent, only slightly below the 1969 gain of about 7 percent. Considering the reduction in expensive overtime hours in 1970 and—even more importantly—the rise in unemployment, this rather slight moderation in the increase in compensation per man-hour is certainly a disappointing development. By way of contrast, in the other post-Korean war periods of declining economic activity the rate of gain in compensation per man-hour moved decisively lower as the economy slowed.

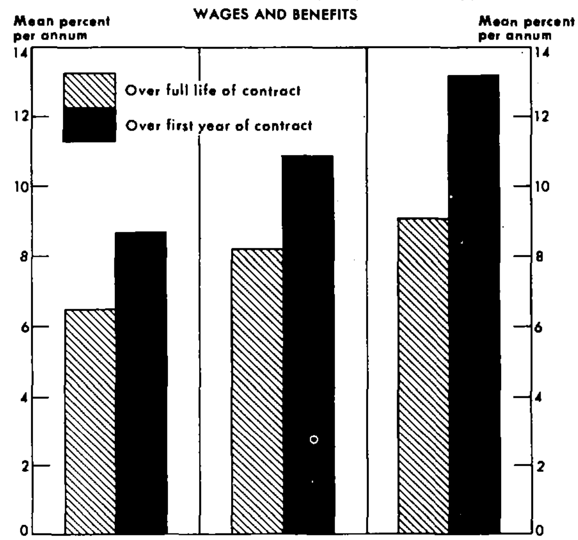
In the fourth quarter, the rise in compensation exceeded by a wide margin the gain in output per man-hour, so that unit labor costs rose at an annual rate of about 5.7 percent. The acceleration in unit labor costs in the October-December period reflected the sluggish growth of productivity in the period. This development was mainly attributable to a pronounced decline in output per man-hour occurring in the manufacturing sector, which in turn was largely the result of the automotive strike. In contrast, during each of the two preceding quarters productivity in the private economy had posted relatively large increases which had yielded some moderation in the rise in unit labor costs. A resumption of a more normal growth of output per man-hour should tend to dampen the impact of rising compensation per man-hour relative to the experience of the fourth quarter. However, even allowing for this eventuality, rapidly rising wage rates are continuing to place severe pressures on the price level.

One factor contributing to the strong upward thrust in wages in 1970 has been the breakneck pace of newly negotiated wage contract settlements (see Chart II). During the four quarters ended in December 1970, the mean increase in wages and fringe benefits in newly negotiated contracts covering 5,000 or more workers was 9.1 percent over the life of the contracts, most of which extend for three years. This contrasts with gains of 8.2 percent and 6.5 percent in 1969 and 1968, respectively. During 1970, the first-year adjustments in these contracts

Chart II

MAJOR LABOR CONTRACT SETTLEMENTS

WAGES AND BENEFITS



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

amounted to an astounding 13.2 percent. While huge contract settlements have been negotiated in virtually all sectors of the economy, the problem was most severe in the construction industry. For the year ended in December 1970, new contract settlements in the construction sector have resulted in a mean first-year increase in wages excluding fringe benefits of 18.3 percent, while over the life of the contract the rise has amounted to 14.7 percent. While major contract settlements directly affect the wages of only a relatively small share of the work force, the publicity surrounding them is such that their implications far transcend the number of workers involved. Certainly, one necessary step toward significant and permanent progress in the battle against inflation is a scaling-down of the pace of new collective bargaining settlements.

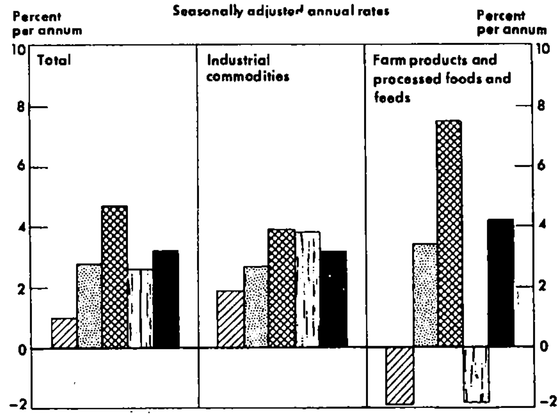
On the price front, the most recent data provide some very tentative signs of an improvement in the underlying inflationary situation. According to preliminary figures—which are sometimes subject to large revisions—the index of industrial wholesale prices increased at a seasonally adjusted annual rate of 1.6 percent in February, about half the rate of gain registered in the past eight months (see Chart III). While industrial prices were moderating, a sharp rise in the index for farm products, processed foods, and feeds resulted in a very rapid 7.6 percent rate of increase in the overall wholesale price index. The acceleration of wholesale agricultural prices was in part attributable to bad weather in the Midwest, which curtailed shipments of livestock.

At the consumer level, January price developments were also somewhat encouraging. The overall consumer price index advanced at a seasonally adjusted rate of 3.4 percent, significantly below the 4.9 percent gain experienced over the second half of 1970. Unchanged food prices accounted for part of this improvement. Indeed, during the past year, moderating food prices have held down the overall increase in consumer prices. In January, however, nonfood commodity prices moderated considerably from recent experience, rising at a seasonally adjusted annual rate of only 2.1 percent. While this development is certainly welcome, it should be emphasized that, over the past two years, one- or two-month slowdowns in this price measure have been quickly reversed.

Chart III

WHOLESALE PRICE CHANGES

Seasonally adjusted annual rates



* February 1971 data preliminary.

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