The Business Situation

The recent performance of most business indicators suggests that domestic economic activity remains fairly sluggish. Indeed, in February the index of industrial production declined despite higher output of automobiles and steel. Moreover, personal income posted only a slim rise in February, and the data for March suggest that the underlying situation in the labor markets remains on the sluggish side. The latest Department of Commerce-Securities and Exchange Commission survey of plant and equipment spending intentions for 1971 indicates a 4.3 percent rise in such outlays. While this increment is slightly larger than that indicated in the previous survey, the magnitude of the increase scheduled for 1971 is still quite modest.

On a more positive note, the inventory-sales ratios in several key sectors have improved somewhat in recent months. Of course, a significant near-term strengthening of sales would pave the way for a more expansionary pace of inventory spending. Moreover, the prospect for such a strengthening in business sales has been enhanced by recent fiscal policy changes. In particular, the new social security legislation will boost social security payments by 10 percent retroactively to the beginning of the year while deferring until 1972 a $2.5 billion increase in social security tax payments that had been budgeted for this year.

Recent consumer price developments have been somewhat encouraging. For the first two months of 1971 the rate of increase in consumer prices slowed considerably from its earlier rapid pace, thus raising the hope that the inflation rate may, at last, be moderating. However, similar improvements in the price situation have emerged in the past only to be sharply reversed. Moreover, in March, industrial wholesale prices rose at a seasonally adjusted annual rate of 3.0 percent, almost double the rise recorded in the prior month. Thus, it is not yet clear that a trend toward a more acceptable pattern of price performance has been firmly established. Moreover, in light of the heavy collective bargaining schedule for 1971, and the large wage gains which will take effect this year on the basis of contracts written in prior years, wage pressures on the price level are likely to remain serious for some time to come.

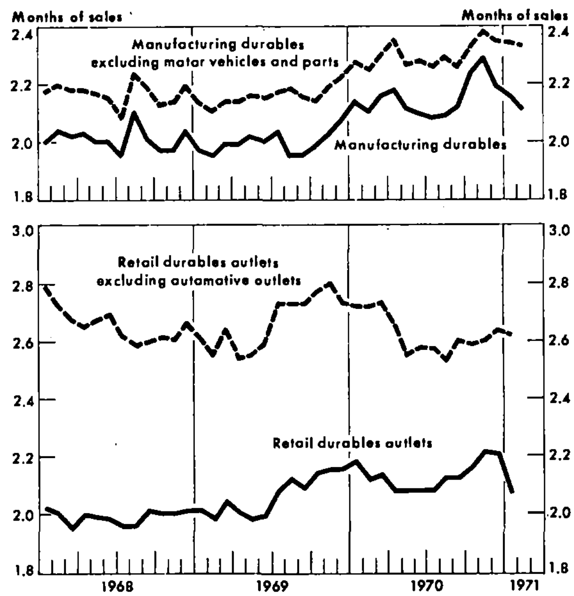
PRODUCTION, INVENTORIES, AND ORDERS

During February, the Federal Reserve Board's index of industrial production edged downward to 164.8 percent of the 1957-59 base, a fall of 0.4 percent on a seasonally adjusted basis. In the previous month, this index had increased as higher automobile and steel output more than outweighed declines in other industry groupings. In February, however, a small gain in automobile output and a 3.9 percent jump in steel production were not sufficient to offset the continued weaknesses in other sectors. Excluding both the automobile and steel components, industrial output fell by 0.6 percent, with production moving lower in virtually all other major groupings. For example, output of consumer goods exclusive of automobiles fell by 0.9 percent, the production of business and defense equipment continued its downward trend, and materials production showed little change.

While the lackluster performance of industrial production in recent months has reflected a broad range of factors, a significant cause has been the failure of post-strike gains in automotive production and sales to meet earlier expectations. New passenger car production in March was about unchanged from the February level of a shade under 9 million units on a seasonally adjusted annual rate basis (see Chart I). These production levels are below the volume of output which had been tentatively scheduled for this period at the turn of the year. The failure to meet these earlier production schedules was largely a response to the disappointing level of automobile sales. In the first quarter, sales ran at a seasonally adjusted annual rate of somewhat more than 8 million units, although they strengthened considerably toward the end of March. The first-quarter sales volume was above the depressed level for 1970 but well below the sales volume recorded in 1969. Moreover, because automotive production in each of the four months since the termination of the General Motors strike has exceeded sales, dealer inventories of new passenger cars accumulated over the first quarter. Thus, unless there is a sustained strengthening in automobile sales, there is little likelihood of any large near-term thrust in production stemming from higher automotive output.

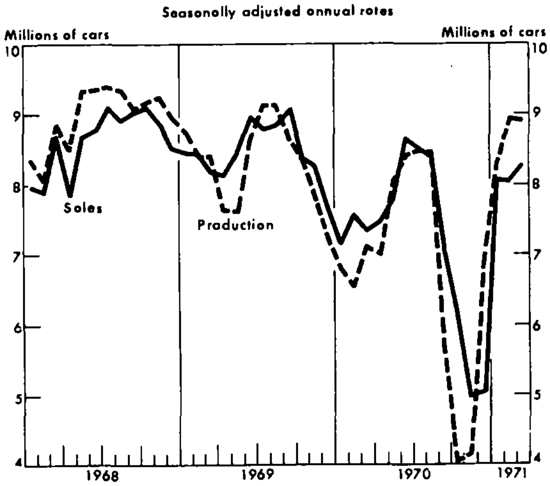
The recent strike-induced movements in automobile production and inventories have tended to distort the overall relationship between sales and inventories. To place these recent developments in better perspective, Chart II shows the inventory-sales ratios for durables manufacturers and retailers both including and excluding the automobile group. As the chart indicates, the durables manufacturers' ratios have improved somewhat in the last three months relative to their very high levels of November 1970. However, at their February positions, both of these manufacturers' ratios still appear a bit high, compared with the experience of the past three years. On the basis of January data, inventory-sales positions of durable goods retailers—both including and excluding the automobile group—are more in line with the behavior experienced in the second half of 1968 and early 1969. In fact, the ratio for durables retailers excluding automobile outlets is below the level that prevailed in the second half of 1969 and early 1970, when inventory spending at these outlets underwent its last significant downward correction. Of course, any substantial strengthening in retail sales would tend to move the ratios lower, thereby paving the way for a more expansionary pace of inventory spending.

Chart II
INVENTORY - SALES RATIOS
Seasonally adjusted



Note: Manufacturing durables plotted through February; retail durables plotted through January.
Source: United States Department of Commerce, Bureau of the Census.

Chart I
DOMESTIC AUTO PRODUCTION AND SALES
Seasonally adjusted annual rates



Source: Ward's Automotive Reports, seasonally adjusted at the Federal Reserve Bank of New York.

In February, new orders for manufactured goods increased by \$0.3 billion on a seasonally adjusted basis. This gain in orders stemmed almost exclusively from a rise in bookings by nondurables manufacturers. In the key durable goods sector, new orders were essentially unchanged from their January level, as a \$0.4 billion increase in producers' capital goods orders offset a large drop in steel mill bookings. This gain in capital goods orders was strongly influenced by a large increase in orders in the shipbuilding industry. Meanwhile, the volume of unfilled orders for durables manufacturers continued to rise slightly but remained substantially below the levels that had prevailed in early 1970. In short, the overall orders situation was little changed in February and still does not suggest a significant near-term strengthening in production.

BUSINESS INVESTMENT AND RESIDENTIAL CONSTRUCTION

The most recent Commerce-SEC survey of plant and equipment spending intentions indicates that business firms are planning to increase their plant and equipment expenditures by a modest 4.3 percent in 1971, with most of the gain scheduled for the second half of the year. If these spending intentions are realized, the year-over-year rise in this spending component in 1971 would be somewhat smaller than the 5.5 percent increase registered in 1970. Moreover, in real terms, this increment in spending may imply no change in the accumulation of new capital goods in the current year.

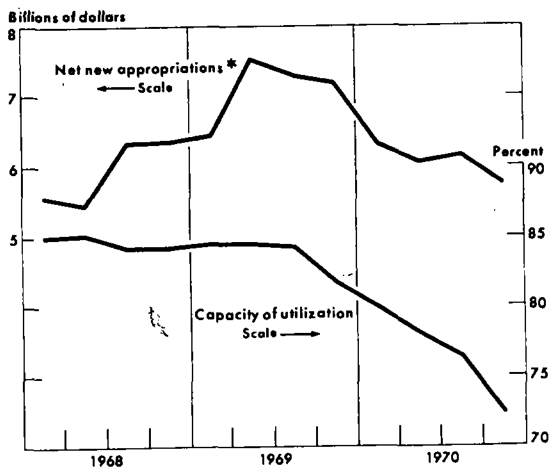
The rise in spending reported in February is somewhat higher than the level indicated in the survey taken last fall that had reported a slim 1.4 percent planned increase in spending for 1971. In part, however, the larger increment now scheduled is a reflection of the fact that actual spending in the fourth quarter of 1970 fell below the level of outlays that had been projected in the November survey. This shortfall in expenditures was partly attributable to reduced purchases of motor vehicles by businesses during the GM strike.

In terms of industry groupings, all of the increase in expenditures planned for 1971 is scheduled for the nonmanufacturing sector, with more than half of the gain arising in the public utilities sector. Despite the general sluggishness in the economy, capacity strains in the public utilities sector have remained quite severe. In contrast, among manufacturing firms, the February survey indicates that plant and equipment outlays in 1971 will be slightly less than the spending level reached last year with virtually every durables industry group in the manufacturing sector scheduling declines in early 1971. Of course, the more distinct weaknesses in spending intentions by manufacturing firms are—among other things—a reflection of sluggishness in output relative to industrial capacity, which has characterized the last year and a half. Indeed, recent data show that manufacturing firms have been operating at a rate utilizing only about three fourths of their capacity (see Chart III). Depressed levels of corporate profits have also tempered the willingness of business establishments to embark on major new capital spending projects.

The sluggish near-term outlook for manufacturers' spending for plant and equipment portrayed in the Commerce-SEC survey is consistent with the latest Conference Board survey of capital appropriations by large manufacturing firms. The latter survey shows a relatively large 7.2 percent drop in net new appropriations in the fourth quarter of 1970 to a level of $5.7 billion (see Chart III). These appropriations, which are often a useful advance indicator of future capital spending, had peaked at $7.5 billion in the second quarter of 1969.

In February, private housing starts remained virtually unchanged at the 1.7 million unit seasonally adjusted annual rate recorded in January. However, the average number of starts initiated in the first two months of 1971 was about 18 percent above the average for 1970 as a whole. Moreover, the February composition of starts shifted toward single-family structures. In fact, single-family starts rose to a seasonally adjusted annual rate of 975,000 units which—except for the unusually high December 1970 figure—was the largest number of single-family structures begun in any month since December 1968. Normally, a shift toward single-family structures implies a somewhat stronger course of spending for residential construction, since these units typically have a higher per unit value than do multifamily housing units. Thus, while housing starts failed to rise in February, the evidence remains convincing that the increased availability and reduced cost of mortgage credit will continue to stimulate spending for residential construction in the coming months.

Chart III
MANUFACTURING APPROPRIATIONS AND UTILIZATION
Seasonally adjusted



*For the thousand largest manufacturing firms.
Sources: The Conference Board, Inc., and Board of Governors of the Federal Reserve System.

EMPLOYMENT, PERSONAL INCOME, AND PRICES

In March the unemployment rate edged upward by 0.2 percentage point, thereby erasing the drop which had occurred in February. The rise in the unemployment rate reflected a decline of 62,000 in the number of employed persons as measured by the household survey and a fairly small rise in the size of the labor force. Among the principal labor force components, the most significant increases in unemployment rates occurred among women in the 20 to 24 age-bracket and among teen-agers of both sexes. For the first quarter as a whole, the unemployment rate averaged 5.9 percent, unchanged from the fourth quarter of 1970. According to the payroll survey, total employment was essentially unchanged in March, as small increases in some sectors offset a decline of 63,000 in manufacturing employment. Since last September, manufacturing employment has declined by 630,000 workers or by about 3.3 percent. The March payroll survey also indicates that the average workweek of production workers in manufacturing rose 0.4 hour from the February figure. Hours worked in February had dropped sharply, probably as a result of seasonal adjustment problems associated with the Lincoln's Birthday holiday. On balance, however, the labor market data for March and for the first quarter as a whole do not indicate any improvement in the underlying situation. At best, the data suggest that the sharp deterioration of labor market conditions which characterized much of 1970 may have stabilized.

The growth in personal income, which was restrained by the declines in employment and hours worked, amounted to $2.2 billion in February. This increment in personal income was only about three fifths of the average monthly rise in income last year. Overall wage and salary disbursements rose by about $1.6 billion. In the manufacturing sector, however, wage and salary payments actually declined, as particularly large decreases in payrolls were recorded in the apparel, fabricated metals, machinery, and chemical industries. All the nonwage and salary components of personal income showed little change in February, thus rounding out a rather dismal performance of personal income in that month.

For the second consecutive month the rate of increase in consumer prices lessened significantly in February relative to the very rapid increase experienced in the past several years. On a seasonally adjusted basis, the overall consumer price index rose at an annual rate of 2.0 percent following the 3.4 percent rate of increase in January. The slowing in consumer price increases in February materialized despite the fact that food prices—which make up about one fourth of the overall index—rose at an annual rate of 5.2 percent. In contrast, prices of nonfood commodities on a seasonally adjusted basis declined at a 1.0 percent annual rate, the first such fall in this measure of prices since February 1965. Services prices also moderated appreciably in February, posting their smallest monthly increase since April 1967. In large part, however, the moderation in services prices reflected the sharp drop in rates on home mortgages. On the whole, the performance of consumer prices in February, coming on the heels of the January improvement, raises the hope that the inflation rate may at last be moderating. However, it would be a mistake to draw sweeping conclusions from two months' data. Only last year, a similar slowdown in the rate of consumer price increases in July and August was followed by the resumption of rapid inflation.

In March, industrial wholesale prices rose at a seasonally adjusted annual rate of 3.0 percent, almost double the increase registered in February. Most of this acceleration was caused by higher prices for materials used in construction, including lumber and structural steel. For the three months ended in March, industrial wholesale prices increased at an annual rate of 2.8 percent, significantly below the pace for 1970 as a whole but still a rapid increase considering the sluggishness in the economy. Wholesale agricultural and food prices rose at a seasonally adjusted annual rate of about 1 percent in March, after having posted very large gains in the two preceding months. Reflecting this marked slowing in food price increases, the overall wholesale price index also moderated in March and posted a gain of 3.3 percent on a seasonally adjusted annual rate basis.