The Business Situation

Business activity continues to recover at a rather slow pace in a highly inflationary atmosphere. Gross national product (GNP), after adjustment for price inflation, advanced at a seasonally adjusted annual rate of 3.7 percent in the second quarter, well below the growth rate registered at the similar stage of each of the three other post-Korean war business recoveries. The most recent monthly data, moreover, do not suggest any immediate change in the rate of recovery. In June, new orders for durable goods declined, industrial production remained virtually stable, and the rise in personal income (net of the increase in social security benefit payments) was smaller than in May. On the other hand, retail sales in June showed another sizable improvement according to the advance report, thus sustaining the strength that had emerged earlier in the quarter. Housing starts also rose further in June, and the continued high level of newly issued building permits implies that some additional upward movement in starts may be forthcoming. The underlying inventory situation seems conducive to a more expansionary pace of inventory spending, inasmuch as inventory-sales ratios in most sectors are at comfortable levels. However, the rundown of strike-hedge steel inventories is likely to limit the overall rate of inventory investment during the coming months.

Recent price developments continue to be thoroughly disappointing. Aside from some temporary moderating influences, there is little, if any, evidence of a slowing in the rate of inflation. In fact, during the most recent months, both consumer and wholesale industrial prices have been climbing more rapidly than they did earlier in the year. Cost pressures, moreover, remain very strong.

GROSS NATIONAL PRODUCT

According to preliminary estimates by the Department of Commerce, the market value of the nation's output of goods and services rose by $19.7 billion during the second quarter to a seasonally adjusted annual rate of $1,040.5 billion. This gain was a shade higher than the average advance over the previous two quarters, the first of which was depressed by the automobile strike and the second considerably swollen by the subsequent rebound in auto production. Slightly more than half of the GNP growth in the April-June period took the form of higher prices, leaving the rise in real GNP at a 3.7 percent annual rate.

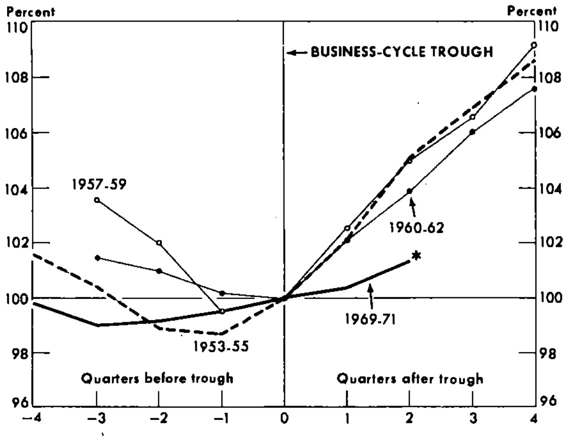
Since the fourth quarter of last year, which has been tentatively identified by the National Bureau of Economic Research as the trough quarter of the contraction, real output has grown at a 5.8 percent annual rate. However, the magnitude of the rise in real GNP over this period is biased upward because economic activity in the fourth quarter was, as noted above, temporarily depressed by the automobile strike. With certain allowances for the effects of the strike, the growth rate in real GNP since the cyclical trough has been about 1½ percent, or 3 percent in annual rate terms. Whatever the precise impact of the auto strike, it is clear that the upswing in real GNP in the two quarters since the cyclical trough has been very modest by comparison with the experience in the three other post-Korean war recovery periods. For example, over the two quarters following the troughs of the 1953-54 and the 1957-58 recessions, real GNP expanded by about 5 percent, or at an annual rate of 10 percent. Similarly, two quarters after the 1960-61 recession bottomed out, advances in real GNP amounted to a substantial 4 percent, or an 8 percent annual rate (see Chart I).

Recent movements in the Federal Reserve Board's index of industrial production (which has been substantially restructured and revised)[1] also attest to the slow tempo of recovery. After having risen 0.7 percent in April and again in May, it edged upward in June by only 0.1 percent. Despite the added thrust provided by strike-related gains in automobile and steel production, the overall rise in industrial output since last November has been a modest 4.3 percent, thus leaving the index in June 4.4 percent

[1] See "Industrial Production—Revised and New Measures", *Federal Reserve Bulletin* (July 1971), pages 551-76.

Chart I

REAL GROSS NATIONAL PRODUCT IN FOUR ECONOMIC CONTRACTIONS AND RECOVERIES



Note: The business-cycle troughs, as identified by the National Bureau of Economic Research, are August 1954, April 1958, February 1961, and November 1970 (tentative).

* Adjusted at the Federal Reserve Bank of New York for the impact of the automobile strike.

Source: United States Department of Commerce.

below the pre-recession peak attained in September 1969. Sharply reduced levels of steel production will retard the growth of the overall index in the near future, as consumers work off their strike-hedge inventories of raw or semifinished materials.

During the second quarter, current-dollar final expenditures, i.e., GNP net of inventory investment, climbed $18.2 billion, about equal to the average of the two preceding quarters. This second-quarter rise in final expenditures was paced by a large $15.5 billion advance in consumer spending, as outlays for services and in particular nondurable goods posted considerable increases. The second-quarter gain of $2.4 billion in consumer spending on durables stemmed partly from an advance of $1.4 billion in outlays on automobiles and parts. The latter, in turn, reflected to a large extent the continued strength in sales of imported cars.

Over the first six months of 1971, sales of new domestic passenger cars were running at a seasonally adjusted annual rate of 8.3 million units (see Chart II). This figure, although well ahead of the total for 1970, was somewhat below the 8.5 million units averaged over 1968 and 1969. In contrast, total auto sales, at just under 10 million units during the first six months of this year, have surpassed the 1968-69 average of 9.6 million units. The difference is accounted for, of course, by the dramatic increase in sales of imported cars. Imports were selling at a 1.8 million unit annual rate in June and at a 1.7 million rate in the second quarter as a whole. This brought their share of the new car market to approximately 18 percent in June, the highest on record except for the strike-distorted final months of last year. Data for July show the rate of sales of domestic autos the same as during the first half of the year, with imports selling at a 1.6 million unit pace.

The large second-quarter rise in consumer spending recorded in the GNP accounts had been suggested by developments in retail sales over the quarter. The preliminary data for June—which could be sharply revised—indicate considerable further strengthening in retail purchasing at the end of the quarter. Indeed, these statistics show that total retail sales advanced by a hefty 1.6 percent in the month, with all major categories sharing in the gain. The June increase followed large upward revisions in the data for each of the three preceding months.

Even with the sizable advance in personal consumption outlays in the second quarter, consumers stepped up their rate of savings. As a consequence, the ratio of personal savings to disposable or after-tax income climbed to 8.3 percent from 8.1 percent.[2] Much, if not all, of this second-quarter rise can be traced to the increase in social security benefit payments that occurred in June. Since the new benefits were retroactive to January 1, the June payments included lump-sum payments for the earlier months of the year as well as the permanent increase in benefits. In the aggregate, this added about $5½ billion (at an annual rate) to second-quarter disposable income. However, the checks probably were received too late in the quarter to affect consumer spending appreciably, with the consequence that the savings rate increased significantly. Nevertheless, the rate was very high even aside from this factor. Indeed, over the six quarters ended in the April-June period, the savings rate averaged 8 percent in contrast to an average of about 6¼ percent over the post-Korean war period as a whole.

[2] Along with the preliminary GNP data for the second quarter, the Department of Commerce released its annual revisions of the GNP and related data for the last three years. In terms of the spending aggregates, most of the revisions were small. However, reflecting an upward revision in personal income and a downward revision in consumer spending, both the level of personal savings and the savings ratio were revised upward by significant amounts. For example, on the basis of the earlier estimates, the savings rate for 1970 was 7.3 percent whereas the revised data show the rate at 7.8 percent.

Spending on residential construction registered another strong advance in the second quarter, rising by $2.9 billion to a record seasonally adjusted annual rate of $39.3 billion; this was 37 percent above the recent low registered during the third quarter of 1970. The prospects for continued gains in home building seem good despite some firming of mortgage market conditions. In June, housing starts totaled 1.98 million units at a seasonally adjusted annual rate. This was the largest volume in any single month of this year and raised housing starts for the second quarter as a whole to a 1.95 million rate, the highest since the third quarter of 1950. Although building permits issued in June backed off somewhat from their very high May reading, the volume of permits for the second quarter as a whole points to the likelihood of a further increase in housing starts in coming months.

In contrast to the thrust provided by residential construction, business fixed investment in the second quarter advanced only at a slim $1.8 billion annual rate as a result of a $2.0 billion gain in outlays on producers' durable equipment and a small decline in outlays on structures. This served to confirm the rather sluggish outlook for capital spending suggested by various surveys, such as the 2.7 percent gain for 1971 indicated by the most recent Department of Commerce-Securities and Exchange Commission survey. Moreover, the already remote possibility that business fixed investment spending would strengthen in the coming months has been further diminished by other recent developments. As measured by the Federal Reserve Board's index of industrial production, output of business equipment slipped in June in continuation of a long decline dating from September 1969. The Federal Reserve also disclosed that manufacturing firms were operating at a low, seasonally adjusted 73.2 percent of their capacity during the April-June period, down from the 78 percent averaged over the first three quarters of 1970 which were relatively free from the effects of the automotive strike.

Inventory accumulation amounted to an estimated $4.7 billion (annual rate) in the second quarter. However, this figure is still quite preliminary, being based on partial returns for the months of April and May. Analysis of inventory movements in recent quarters is complicated by actual and potential labor disputes, but it appears that stockpiling in anticipation of a steel strike accounted for a sizable portion of the second-quarter accumulation. The runoff of these steel stocks in the coming months will, of course, act as a drag on overall inventory spending. Apart from the steel inventory situation, however, the inventory picture is good, with the inventory-sales ratios for all businesses and for most major sectors at comfortable levels. This contrasts with the situation at the turn of the year, when stocks were somewhat high relative to sales.

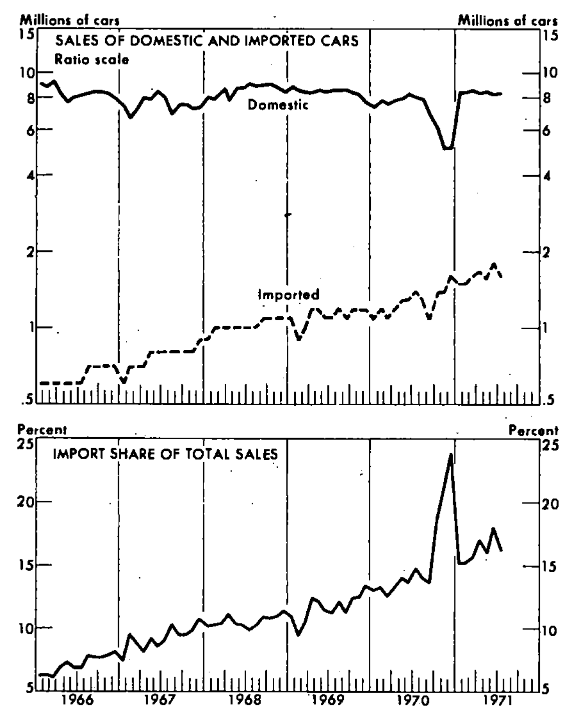
Government purchases of goods and services contributed $2 billion (annual rate) to the second-quarter GNP advance. Federal outlays dropped by $0.7 billion, as a $1.0 billion contraction in defense outlays was only partially offset by a small gain in the nondefense categories. Since peaking in the third quarter of 1969, Federal defense expenditures have fallen by an average of $1 billion per quarter, so that even a leveling-off would serve to bolster GNP growth. In this regard, there are some tentative indications that the prolonged contraction in defense outlays may have run its course. For example, based on the Federal Reserve Board's index of industrial production, defense and space equipment output increased for the second consecutive month in June, although it was still 29 percent below the peak reached in August 1968.

State and local government spending rose at an annual rate of $2.7 billion in the second quarter, as the overall advance was held down by an apparent decline in outlays on structures and capital-type goods. This latter drop was

Chart II

NEW CAR SALES

Seasonally adjusted annual rates



Sources: Seasonally adjusted imported car sales data are from the United States Department of Commerce. Domestic car sales data are gathered from industry sources and are seasonally adjusted at the Federal Reserve Bank of New York.

probably a statistical fluke, since the very heavy volume of state and local borrowing in recent quarters is almost certainly providing an impetus to outlays on structures. Moreover, the Emergency Employment Act of 1971, which was signed into law during July, will increase Federal grants to state and local governments by an additional $1 billion during the current fiscal year. In turn, state and local spending will rise as these funds are used to provide public service jobs for the unemployed. Thus, state and local outlays could show larger gains over the coming quarters.

Net exports of goods and services, according to still incomplete data, plummeted from a $4.2 billion annual rate in the first quarter to a scant $0.1 billion in the April-June period as a result of a large spurt in imports and some slippage in exports. This sharp decline in net exports produced a $4.1 billion drag on the overall rise in GNP. The Commerce Department noted that imports of raw materials had increased, partly in anticipation of a steel strike. Observers point out that steel imports could subside substantially in the second half of this year, since foreign steel sellers may already have exhausted their voluntary quotas on 1971 shipments to the United States.

PRICES, WAGES, AND PRODUCTIVITY

Price developments during the second quarter reflect a combination of some major setbacks in the struggle against inflation and a few very tentative and isolated gains. On balance, there are virtually no signs of a significant lessening in the pace of inflation. The most comprehensive available measure of price movements, the GNP deflator, slowed to a 4.2 percent annual rate of increase in the second quarter, down from the 5.3 percent rate of the January-March period. This deceleration is an overstatement, however, since the first-quarter deflator was given a temporary boost by the Federal pay raise, which accounted for roughly 1 percentage point of the increase in that period. Moreover, since the deflator is a weighted average of many component price indexes, with the weights being determined by output in each current quarter, shifts in the composition of output can obscure underlying price trends. Both the final quarter of last year and the first period of 1971 were substantially affected by the huge swings in the durable consumption goods component, which exaggerated the pace of inflation in the fourth quarter and may have understated it in the first quarter. In the second quarter of 1971, a continuing shift in the composition of output toward relatively low-priced items may have resulted in a further overstatement of the extent to which inflation moderated. Using the output weights from the year 1958—the only full-year period for which such data are available—in an attempt to abstract from these compositional movements indicates that the annual rate of increase in the deflator during the April-June period was 5 percent rather than the 4.2 percent indicated by the current weights scheme. Although somewhat of an improvement from the 5.8 percent change (1958 weights) in the first quarter (after excluding the Federal pay raise), the 5 percent figure is not much lower than the 5½ percent advance averaged over the four quarters of last year. A similar deflator that uses weights from the fourth quarter of 1965 leads to essentially the same results.

Wholesale price changes must be interpreted as extremely discouraging. Movements in the overall index have been dominated by the erratic behavior of agricultural prices. Despite a July decrease, prices in the farm products, processed foods, and feeds category have advanced at a seasonally adjusted annual rate of 4.2 percent thus far this year, in contrast to their 1.2 percent decline during all of 1970. More significant, however, are the movements in prices of wholesale industrial commodities. These increased at an annual rate of 2.8 percent in the first quarter and 5.2 percent in the second quarter, and soared upward at an 8.4 percent rate in July. During 1970, such prices had risen by 3.6 percent.

Consumer prices made a poor showing in June, when the seasonally adjusted index spurted ahead at a 5.5 percent annual rate. This was somewhat below May's very high 6.7 percent upsurge, but considerably above the 3 percent advance registered over the first four months of this year. The Bureau of Labor Statistics' mortgage interest rate index declined for the sixth consecutive month in June and again retarded the rise in total consumer prices. Over the first half of 1971, the total consumer price index rose at a 4 percent annual rate, but without the benefit of declining mortgage rates it would have advanced at a rate of about 5 percent.

Movements in wages and salaries have provided little or no relief from inflationary pressures. Measured from a year earlier, the index of seasonally adjusted compensation per man-hour for the private nonfarm economy grew by a rapid 7.9 percent in the second quarter of 1971, the largest increase since the closing quarter of 1968. Output per man-hour rose by 3.5 percent from the second quarter of 1970 to the second quarter of 1971, a gain somewhat more modest than was experienced at similar stages of previous economic recoveries since the Korean war. As a consequence, labor costs per unit of output rose 4.2 percent, representing a definite slowdown from the peak year-to-year increase registered in the first quarter of 1970. Nevertheless, unit labor costs are still rising at an exceptionally rapid rate. This upward movement, moreover, contrasts with declines in parallel periods of previous cycles. By the second quarter after the cyclical trough, unit labor costs had fallen 2.7 percent following the 1953-54 recession, 0.4 percent after the 1957-58 contraction, and 1.2 percent subsequent to the 1960-61 downturn. These earlier declines resulted from somewhat more rapid rates of productivity growth than we have had this time and substantially smaller advances in compensation per man-hour.

The latest Bureau of Labor Statistics survey shows that the rate of increase in wages and benefits under major collective bargaining agreements was smaller during the first half of 1971 than for the full year 1970. The mean life-of-contract wage and benefit changes negotiated from January through June was 8.3 percent per year for all industries, in contrast to 1970's 9.1 percent. However, these data, which exclude possible cost-of-living wage increases, do not warrant the conclusion that there has been a slowdown in the pace of the advances. Manufacturing contracts signed during the first six months of this year provided for slightly larger average wage rate increases than last year. Moreover, very few construction labor agreements were included in the first six months' data, even though a large number normally occur during the April-June quarter. These construction settlements may well show up in the surveys covering the latter half of this year, giving an upward push to the figures for that period. In addition, the hefty settlements recently reached in primary metals, transportation, and communications will leave their imprint on the figures gathered for the third quarter of this year.

The rapid rise in labor costs has occurred despite the continuing generally soft condition of labor markets. A mixed picture emerges from the most recent data. According to the July survey of nonagricultural establishments, seasonally adjusted payroll employment declined by 200,000 workers, the second consecutive monthly decrease. Only about one fourth of this drop can be traced to the increase in the number of persons involved in work stoppages for the entire survey week. The July household survey, on the other hand, which counts striking workers as employed and further differs from the payroll survey in terms of coverage and seasonal adjustment techniques, indicated a rise in employment of 500,000. Since the seasonally adjusted labor force grew by 700,000 persons, the unemployment rate rose to 5.8 percent, up from the June figure of 5.6 percent which is believed to have been artificially depressed by seasonal adjustment problems.