The Business Situation

President Nixon's announcement on August 15 of a set of new economic policies for the country has apparently provided a significant and welcome boost to confidence in the nation's economic prospects. Such a gain in confidence will, if sustained, help greatly in bringing about the stronger business expansion the President hopes to achieve.

Prior to the President's announcement, business developments had continued to attest to the sluggish character of the recovery. In July, industrial production declined for the second consecutive month as labor contract deadlines and strikes precipitated decreases in the output of steel and other raw materials. Moreover, there was only a small increase in personal income after making allowance for a special factor that had caused an unusually large rise in June. In addition, the advance report on retail sales indicated a contraction in July. Furthermore, the unemployment rate in August, according to a survey in the second week of the month, rose from 5.8 percent to 6.1 percent, almost back to the recent 6.2 percent high of May. One area of economic strength was residential construction. Housing starts increased sharply in July to a figure that eclipsed the previous record, and building permits moved appreciably higher, suggesting that further gains in starts might be forthcoming.

It was against the background of generally slow economic expansion, accompanied by persistent inflation and mounting international financial pressures, that a basic change in the approach to achieving both economic growth and price stability was announced by President Nixon in mid-August. He used the powers available under the Economic Stabilization Act of 1970 to order a ninety-day freeze on wages and prices. A surcharge of 10 percent was imposed on a wide range of products imported by the United States. The convertibility of dollars into gold and other reserve assets was temporarily suspended. And several changes in taxes to stimulate a more rapid expansion in production and employment were recommended to the Congress. These recommendations included the elimination of the 7 percent excise tax on automobiles, retroactive to mid-August; the establishment for one year, also retroactively, of a 10 percent investment tax credit on new machinery and equipment, provided it is American made, to be followed by a permanent 5 percent credit; and the bringing forward to January 1972 of reductions in personal taxes previously scheduled to take effect at the beginning of 1973 through higher standard deductions and personal exemptions.

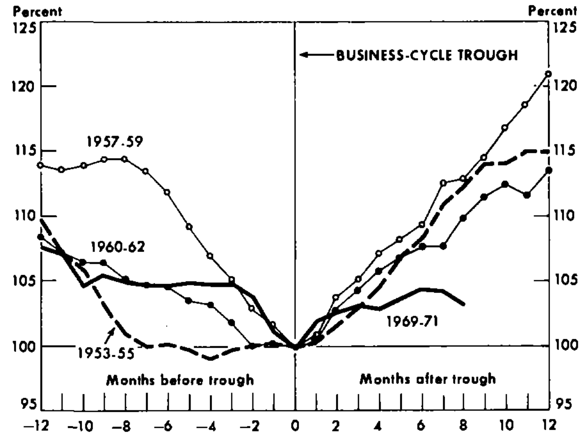
PRODUCTION, SHIPMENTS, AND INVENTORIES

The Federal Reserve Board's index of industrial production declined by 0.8 percent in July, the second consecutive monthly drop. Reduced output of raw materials —notably steel, copper, and coal—accounted for most of this latest decline, with labor disputes playing an important role. In the steel industry, production was depressed as users worked down the ample stocks of steel mill products that had been accumulated earlier in the year in anticipation of a strike. Moreover, a number of large producers began to bank their furnaces as the July 31 contract settlement deadline approached, thereby cutting further into steel output. A strike in the copper industry significantly curtailed the output of nonferrous metals, while the railroad labor dispute cut progressively into coal production because of the reduced availability of freight cars. Even apart from these special situations, industrial production was distinctly lackluster. The output of consumer goods showed essentially no change, while the output of both business and defense equipment declined.

The July decrease in production underscored the continued slow pace of the current economic recovery. In the eight months following November 1970, which has been tentatively designated by the National Bureau of Economic Research as the trough month of the 1969-70 recession, total industrial production rose only 3.3 percent even though output had been abnormally depressed in the trough month by the General Motors strike. In sharp contrast, the gains in industrial output over the first eight

Chart I

INDUSTRIAL PRODUCTION 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).

Source: Board of Governors of the Federal Reserve System.

months after the troughs of the three previous post-Korean war recoveries ranged from 10 to 13 percent (see Chart I). The limited data available for August do not indicate there was any step-up in production during the two weeks immediately before the President's new economic program was announced.

The policy changes initiated on August 15, however, will probably have a stimulating effect on economic activity, and perhaps most immediately on the sale and production of domestic automobiles. There may be a quickened pace of demand for automobiles in general in response to the proposed elimination of the excise tax. Sales may be additionally spurred by the temporary price freeze. Beyond this, the Administration's new economic policies will tend to reduce the prices of domestic automobiles relative to prices of imported cars. The latter are now bearing a temporary surcharge of 6.5 percent in addition to the regular 3.5 percent duty. (The surcharge is not the full 10 percent inasmuch as total import duties on any item may not exceed the ceiling prescribed by the Tariff Act of 1930, which for autos is 10 percent.) Upward movements in the exchange rates of foreign currencies will also tend to push up the prices of imported cars.

It does not seem likely, on the other hand, that the proposed 10 percent investment tax credit will generate sizable near-term gains in the output of business equipment. Most businessmen presumably will defer any firm decisions about undertaking additional new investments until the Congress, which reconvened on September 8, acts on the President's recommendation. Moreover, business spending on plant and equipment during the immediate future will certainly be tempered by the rather sizable amounts of excess capacity that currently exist in many industries. In the second quarter, the rate of capacity utilization in manufacturing was only 73 percent or well below the rates that prevailed in 1968, the last full year of economic expansion. The most recent Department of Commerce-Securities and Exchange Commission survey of plant and equipment spending intentions underscored the weakness in the near-term outlook for capital spending. This survey, which was completed too early to be influenced materially by the President's announcement, showed further cutbacks in plans for 1971, indicating a rise over 1970 of merely 2.2 percent, compared with the 4.3 percent increase that had been slated six months ago. However, the fact that the President's proposal calls for a 10 percent tax credit only until August 1972, and for a subsequent drop in the rate to 5 percent, provides a special incentive for businesses to undertake new capital spending programs within the period during which the higher tax credit will be in effect.

The most recent data on business inventories and sales continue to show improvement in the inventory-sales ratios for most sectors. Total manufacturing and trade sales increased in June by $1.4 billion, while inventories rose by a less than proportionate $0.4 billion.[1] Consequently, the inventory-sales ratio for all business fell to the lowest figure since mid-1966. Data for both shipments and inventories were somewhat distorted by the completion of billings in June on a large amount of aerospace equipment, which reduced reported inventories by over $500 million while increasing shipments by the same amount. However, even after adjusting for this special factor, there was a decline in the overall inventory-sales ratio. To be sure, these adjusted inventory data indicate

[1] The Department of Commerce has announced an upward revision of $0.8 billion in the gross national product (GNP) estimate for the second quarter, reflecting in part the availability of inventory spending data for the entire quarter. GNP for the quarter is now estimated at $1,041.3 billion on a seasonally adjusted annual rate basis, and the annual rate of real GNP growth is put at 4.1 percent rather than 3.7 percent. Net exports, however, are reported as having dropped by $6.4 billion (seasonally adjusted annual rate) rather than $4.1 billion, but this downward revision was more than offset by upward adjustments in other components, including $0.8 billion in consumption spending, $0.9 billion in business fixed investment, and $1.0 billion in inventory accumulation. Corporate profits before taxes are shown as rising during the quarter by $2.9 billion to $82.0 billion (seasonally adjusted annual rate).

a more expansionary pace of inventory spending than do the unadjusted data. After the adjustment, the book value of total business inventories shows a rise in June at an annual rate of $11.3 billion, more than double the gain suggested by the unadjusted figures. This more robust rate of inventory accumulation exceeded the increases registered in the three preceding months and was well ahead of the rate of spending in January and February, when relatively high inventory-sales ratios tended to dampen inventory investment.

In July, data for the manufacturing sector alone show there was a decline in inventories and a relatively greater decrease in sales. Consequently, the inventory-sales ratio rose. However, after adjusting the previous month's data for the unusually large aerospace equipment billings, the July decrease in inventories was larger than that in sales, and the inventory-sales ratio was virtually unchanged from the May and June levels.

New orders received by manufacturing industries in July advanced by $1.0 billion, owing entirely to a 3.3 percent rise in orders for durable goods. Heavier orders for defense goods, which tend to be especially large in the first month of the fiscal year, accounted for about $500 million of the overall advance. Sizable gains in new orders were also recorded in the automobile, aerospace, and machinery industries. Bookings for primary metals declined, however, largely as a result of the labor contract negotiations in the copper and rail industries. On balance, the pattern of new orders for manufacturers' goods has not yet displayed the clear and pervasive upward thrust that accompanied the other post-Korean war recoveries.

RESIDENTIAL CONSTRUCTION

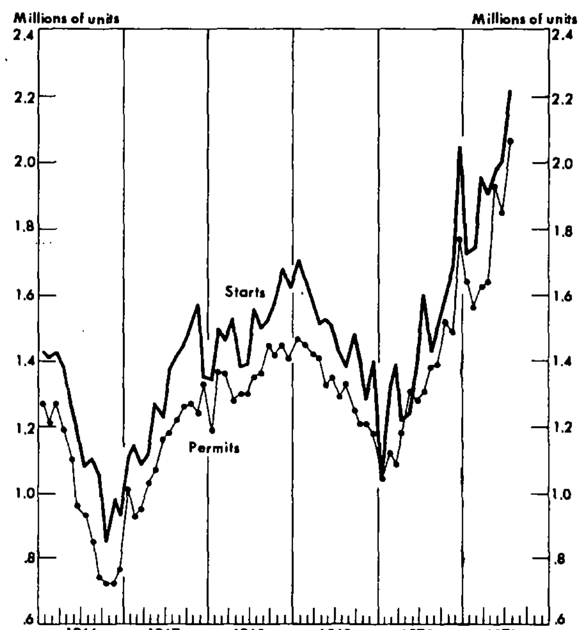
Residential construction continued to be an economic bright spot in July, as total private housing starts jumped 11.2 percent to a seasonally adjusted annual rate of over 2.2 million units (see Chart II). At this rate, starts exceeded the previous record for a single month (in August 1950) by about 100,000 units. The strength of the current housing boom is underscored by the fact that the July figure was approximately 500,000 units above the peak level of starts recorded in January 1969 at the end of two full years of expansion in residential construction. Most of the July gain reflected an increased volume of multifamily units. However, single-family starts amounted to 1.2 million units, a relatively high figure by historical standards. The seasonally adjusted number of building permits also soared in July, reaching a record annual rate of almost 2.1 million units (see Chart II). This high level, together with a large backlog of permits for which actual construction activity has not yet begun, indicates that further gains in housing starts may well be forthcoming in the months ahead. The total supply of living units is being enlarged by continued strength in the demand for mobile homes. In June, factory shipments of mobile homes were running at a seasonally adjusted annual rate of 490,000 units, up dramatically from the 369,000 units shipped a year earlier.

The value of total new construction declined in July for the first time in twelve months. Industrial construction continued its generally downward movement from the high of October 1969, and commercial construction dropped sharply after a June surge. However, expenditures on both public construction and private residential construction showed strong gains. The near-term outlook for residential construction has been bolstered, moreover, by recent developments in the mortgage market that should have a favorable influence on the supply and cost of mortgage credit. Perhaps the most important of these developments was the sizable decline in interest rates on corporate bonds in the week following President Nixon's announcement of the wage-price freeze. If these declines are at least partially maintained, existing rates on new

Chart II

PRIVATE HOUSING STARTS AND BUILDING PERMITS

Seasonally adjusted annual rates



Source: United States Department of Commerce, Bureau of the Census.

home mortgages will make the latter a more attractive investment for thrift institutions and other suppliers of mortgage credit. Furthermore, the Administration indicated in early August that it would seek to preserve the 7 percent ceiling on Government-underwritten mortgages by allowing the Government National Mortgage Association (GNMA) to purchase up to $2 billion in mortgages at a price not below 95 percent of par. In turn, GNMA will sell the mortgages at competitive rates in the secondary market while absorbing the interest cost differential by means of its special assistance fund. In another move taken in August to support the flow of funds to the mortgage market, the Federal Home Loan Bank Board reduced the liquidity requirements of member savings and loan associations from 7.5 percent to 7.0 percent.

INCOME, EMPLOYMENT, AND CONSUMER DEMAND

In July, personal income declined by $11.0 billion, falling to a seasonally adjusted annual rate of $859.1 billion. While this decrease reflected primarily the fact that personal income had been temporarily boosted in June by an increase in social security payments retroactive to the first of the year, the $2.3 billion rise that occurred in July after allowance for this special factor was still relatively small. The average monthly rise between December 1970 and May 1971 had been $5.8 billion. Emphasizing the underlying weakness of personal income in July, total wage and salary disbursements were essentially unchanged, and in manufacturing such disbursements actually declined by about $1.1 billion.

In August, the seasonally adjusted unemployment rate increased to 6.1 percent from the 5.8 percent registered in July, according to the Bureau of Labor Statistics survey of households, as a rise of 500,000 persons in the civilian labor force outpaced an advance in employment of 300,000 persons. This was the second consecutive monthly rise in unemployment and brought the rate almost back to the May high of 6.2 percent. Most of the increase was caused by rising unemployment among teen-age and adult males. The expansion in unemployment of adult men was attributable primarily to the curtailment of production in the steel industry. Nonfarm payroll employment remained essentially unchanged, with construction and manufacturing showing minor declines. Employment in manufacturing has been especially weak during the current recovery, declining slightly from its November 1970 level. In sharp contrast, during the three most recent previous recoveries the number of workers on manufacturing payrolls over the nine months following the business-cycle trough had risen an average of 4 percent.

Retail sales declined by 0.8 percent in July, according to the advance report. This drop, which was centered at nondurables outlets, followed a large increase in retail activity in June. However, the significance of this decline is questionable in view of the highly tenuous nature of the preliminary data. In every month of 1971 the advance report on retail sales has been revised upward, frequently by a significant amount. Whatever the final reading on the July data, the near-term course as well as the interpretation of the retail sales figures will in all probability be substantially affected by the new economic policies. With the savings rate at historically high levels, any bolstering of consumer confidence should have favorable ramifications for retail sales. Moreover, temporary increases might develop if purchases of domestic goods are accelerated on the expectation that prices will rise after the price freeze is terminated. As with other monthly indicators that are stated in dollar terms, however, changes in monthly retail sales throughout the price freeze period will be difficult to interpret relative to recent experience, during which sizable shares of the increases in dollar volume reflected simply advances in prices.

PRICE DEVELOPMENTS

The behavior of prices in the months immediately ahead will of course be dominated by the wage and price freeze. While it would be premature to speculate to what extent the freeze will affect the rate of inflation in the longer run, the large drop in long-term interest rates in the days following the President's August 15 announcement suggested that the freeze had the effect at least of temporarily reducing inflationary expectations. However, a lasting reduction in the rate of inflation will depend heavily upon decisions that are yet to be made for Phase Two, the time after the ninety-day freeze. The Cost of Living Council, which was appointed last month by the President, is currently considering various proposals for the achievement of price and wage stability over the longer run.

The highly inflationary background against which the freeze was initiated is illustrated by the recent performance of industrial wholesale prices. In August, the index of these prices rose at a seasonally adjusted annual rate of 6.4 percent, with almost all of the increase having taken place before the price freeze. This huge rise had been exceeded in July, when the index jumped at an annual rate of 8.4 percent, a record increase for the last fifteen years. Industrial prices during the first half of the year had advanced at an annual rate of 4.0 percent, a somewhat more rapid pace than for 1970 as a whole. In short, despite almost two full years of distinctly sluggish activity in the industrial sector, prices had continued to advance at inflationary rates that were without modern precedent for a period characterized by such marked weakness in demand.

The overall performance of the consumer price index has been modestly better this year than that experienced in 1970. During the first half of the year, this improvement had partially reflected declining home mortgage interest rates. In July, on the other hand, there was a small increase in mortgage interest rates; nonetheless, the consumer price index rise slowed further to a 2.4 percent annual rate. This followed much larger increases in the two preceding months. Smaller advances in food, nonfood commodities, and to a less extent service prices all contributed to the July easing. This substantial slowing, however, might well have proved temporary with no price freeze, in view of the steep rise in wholesale industrial prices during the preceding several months. Increases in wholesale prices usually affect consumer prices after some lapse of time. The mid-August freeze may therefore have prevented the recent advances in wholesale prices from having as much repercussion on consumer prices as would otherwise have occurred.