The Business Situation

The Administration's new domestic economic policy to restrain wages and prices and to stimulate aggregate demand signaled a major change in the strategy of fighting the nation's twofold problem of inflation and high unemployment. Although it is far too early to assess the full impact of the new policy, it has helped to restore consumer and business confidence. The price freeze, combined with the proposed removal of the excise tax on automobiles, has been met by a rise in new car purchases. However, other fiscal steps designed to stimulate business activity will require more time to have their effect.

The initial impact of the price freeze is evident in the latest data on wholesale prices, which declined in September in sharp contrast to the rapid increases of other recent months. The persistence and severity of inflation in recent years make it clear, however, that wide public support of Phase Two policies is essential if cost and price pressures are to be substantially reduced.

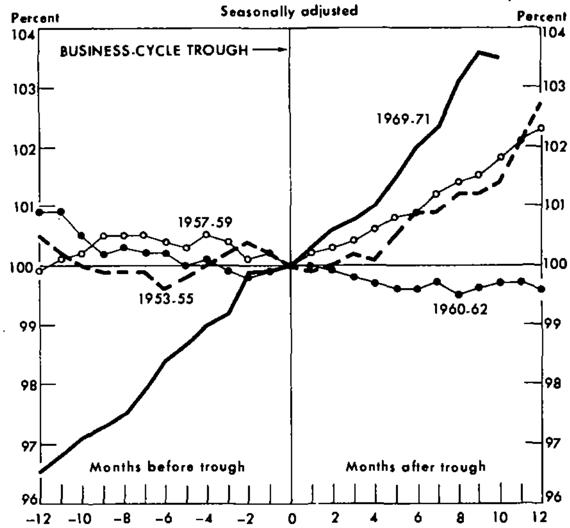
THE CURRENT INFLATION

The wage-price freeze was necessitated by the failure of sluggish demand conditions to retard price increases. Between November 1969 and November 1970, the months tentatively designated by the National Bureau of Economic Research as the period of recession, industrial wholesale prices rose at a 3.6 percent seasonally adjusted annual rate—a rise nearly as fast as the gain in the preceding twelve months. In contrast, industrial prices had generally stabilized during previous post-Korean war downturns (see Chart I). Moreover, since the trough these prices have risen at an even more rapid rate of 4.8 percent. Indeed, data for July and August—which because of survey timing excluded virtually any effect of the freeze—indicated industrial wholesale prices averaged an alarming 7½ percent annual rate of advance. The continuation of sharp inflation in the face of a recession and the subsequent sluggish recovery appears to have resulted largely from the fact that the excess demand which kicked off the inflation in mid-1965 was reinforced, and eventually superseded, by widespread and severe cost pressures. At least as important, these pressures continued for so long that the expectations of further price rises became firmly entrenched and generated an inflationary force of their own. It should be noted, however, that there has been a high level of demand in some areas. Better than one fourth of the overall rise in the index of industrial wholesale prices (not adjusted for seasonal variation) through August was caused by the run-up in costs in the residential construction area, which has been expanding rapidly since its low in the first quarter of 1970. Prices of lumber and other construction materials rose at a 20 percent annual rate in the first eight months of 1971.

Under the freeze, the rise in industrial wholesale prices came to an abrupt halt in September. In fact, the index actually eased fractionally despite a few cases of increase. Most of these advances—such as that for iron and steel scrap—apparently resulted from the provision that firms had the choice of setting prices either at the level recorded on May 25, 1970 or at any level charged in the thirty days preceding the President's announcement. These small price increases were outweighed chiefly by a decline in wholesale automobile and truck prices, which reflected manufacturers' rebates to dealers for 1971 models. Agricultural prices dropped substantially in September, and thus the total wholesale price index fell at an annual rate of over 4 percent.

The behavior of consumer prices through August of this year was better than that of wholesale industrial prices. This performance, however, resulted largely from the rundown in mortgage interest rates that reflected Government subsidy programs and the general easing earlier in the year in the capital markets. In the first eight months of the year, the total consumer price index rose at a 3.9 percent seasonally adjusted annual rate, substantially less than the 5.5 percent rise in 1970 and the 6.1 percent in 1969. Excluding mortgage rates from the index, however, consumer prices rose at a 5.0 percent rate through July, much closer to the 1970 rate of advance. In August, the total index also rose at a 5.0 percent sea-

Chart I
INDUSTRIAL WHOLESALE PRICE INDEX IN FOUR ECONOMIC CONTRACTIONS AND RECOVERIES
Seasonally adjusted



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: United States Department of Labor, Bureau of Statistics.

sonally adjusted annual rate, reflecting increases in a number of items. This survey was almost entirely completed before the imposition of the wage-price freeze on August 15. Even over the September-November period, however, the consumer price index is likely to show some increase since several items included in the series—such as sales and property taxes and some foods—are not covered by the freeze. Further, some of the components of the index are priced on a quarterly or semiannual basis. For these items, increases which took effect before August 15 will show up in the coming months.

CONSUMPTION AND INVESTMENT

The Administration's policies designed to promote the recovery of economic activity are aimed at stimulating consumption and investment. To concentrate the stimulus on the domestic economy, the President imposed a temporary surtax of up to 10 percent on dutiable imports. Another major method of stimulating consumption is the recommended removal of the 7 percent Federal excise tax on automobiles retroactive to August 15. The immediate impact of the President's recommendations was to boost sales of both domestically produced and foreign-made cars, since the surtax did not apply to those imports already in inventory or in transit at the time of the announcement. Aside from this short-run phenomenon, the stimulus should be largely confined to domestically produced automobiles, since the import surtax—which is 6½ percent on automobiles—will about cancel out the effect of the excise tax removal on prices of imported cars.

Led by increased sales at automotive outlets, retail sales in August advanced by 1.7 percent, according to the preliminary report. Sales of imports jumped to a 1.8 million unit seasonally adjusted annual rate in August, compared with the already high 1.6 million unit rate averaged over the first seven months of 1971. This surge, however, probably reflected a rush to avoid the surtax or higher prices that would result from realignments in exchange rates. In September the depletion of stocks on the West Coast that resulted from the dock strike there sharply reduced sales to a 1.3 million unit seasonally adjusted annual rate. Data for domestic cars indicate the sales pace rose to a 9½ million unit rate in September, compared with 8⅓ million in the first eight months of the year. Part of this increase in sales of domestic automobiles doubtless reflected attempts by some consumers to avoid future price increases.

In addition to the price freeze and the removal of the excise tax on automobiles, consumption may be stimulated by the boost to disposable income from the proposed acceleration to 1972 of the increases in the personal income tax exemption and the standard deduction that had been scheduled to take effect in 1973. Personal income growth has been moderate this year, aside from special factors such as the Federal Government pay raise in January, the increase in social security benefits in June, and the postal workers' pay raise in August.

The Administration's chief proposal to stimulate investment was the recommendation of an investment tax credit for business spending on domestically produced machinery and equipment, which has been a particularly weak area. The effects of the credit will in all likelihood be spread over a long period since there is often a long lead time between the initial planning stage and the start of actual production on major capital projects. In the near term, such factors as continued low capacity utilization and poor profits are likely to hold down spending on plant and equipment.

Among other components of investment, the outlook for residential construction continues buoyant while prospects for a pickup in inventory spending seem to have improved. The rebound in home building brought activity to record levels during the summer months. In both July and August, total private housing starts ran at a record 2.2 million unit seasonally adjusted annual rate, compared with 1.9 million in the first half of 1971 and 1.5 million for all of 1970. The volume of building permits issued by local authorities also was very strong during the midsummer months, though the August figure was a bit below July's record pace. These trends, together with the continued availability of funds in the mortgage markets, suggest home building will continue at a rapid rate in the near term.

Inventory investment could also become an expansionary force in the months ahead. Inventory positions—as indicated by inventory-sales ratios—appear to be in the best shape in over two years. The inventory-sales ratio did rise in August in durables manufacturing, where the problem of excess stocks had been centered. However, the rise stemmed largely from a sharp decline in steel shipments, while the overhang of steel inventories that had been accumulated in anticipation of a steel strike was gradually being worked off. Aside from this factor, the inventories of most durables manufacturers appear to be in reasonable balance with sales.

The realignment of inventories with sales resulted from businesses holding inventory accumulation to a moderate rate for the six quarters that ended in June. On a book-value basis, inventory accumulation in all of 1970 and in the first half of 1971 ran at an annual rate of about $6½ billion—substantially less than the $10 billion and $11 billion increases recorded in 1968 and 1969, respectively. Inventory spending at all levels of business remained quite moderate in July. August data, which are currently available for manufacturing only, indicate there was also no accumulation by manufacturers in that month. With the ratios of stocks to sales at relatively low levels, any improvement in the sales outlook can be expected to generate a step-up in the rate of accumulation.

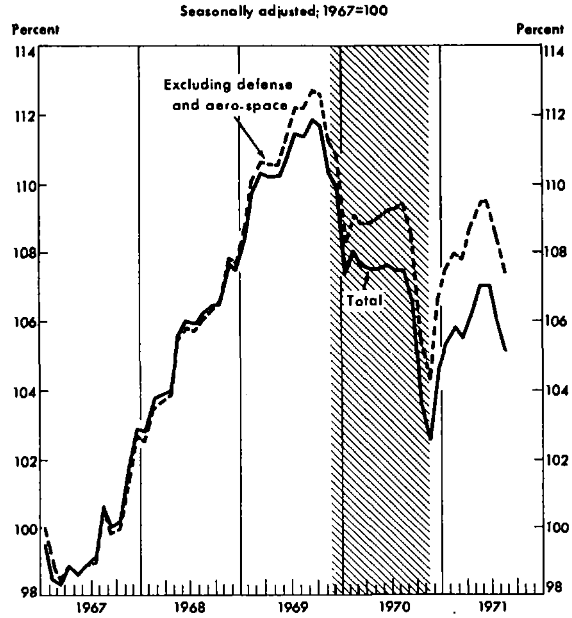
PRODUCTION AND EMPLOYMENT

It is still too early for the improved prospects for demand to have had a measurable effect on production and employment activity, where the recovery has been feeble. Indeed, industrial production was about unchanged in June and declined in both July and August to a level only 2.4 percent above the November 1970 trough. Moreover, even this gain is overstated since the General Motors strike depressed November output. Nine months after the 1961 cyclical trough, industrial production had risen 11.4 percent, and over the corresponding period after the 1958 cyclical low the rise in output totaled 14.5 percent. While some special factors—notably in the defense and steel industries—have dampened production, the underlying sluggishness indicates an unusually weak recovery in aggregate demand and a startling leakage into imported goods. The business-cycle downturn coincided with a broad and prolonged cutback in the defense sector but, excluding this component, industrial production in August was still only 3.0 percent above the trough (see Chart II). The reduction in defense output was nevertheless pronounced, bringing production back down roughly to its level at the time of the Vietnam buildup—a decline in output of close to one third.

Another factor depressing the production index in July and August was the inventory situation in the steel industry. For the first half of 1971, steel output expanded rapidly in response to inventory stockpiling demand by users who feared a strike this summer. Production began to decline in July, as the firms banked furnaces in anticipation of a strike. In August steel output fell by one fourth, accounting for almost three quarters of the decline in the overall production index that month. Data on raw steel ingot production, however, suggest there was a substantial recovery in steel output in September.

The volume of new orders received by manufacturers

Chart II
INDUSTRIAL PRODUCTION
Seasonally adjusted; 1967=100



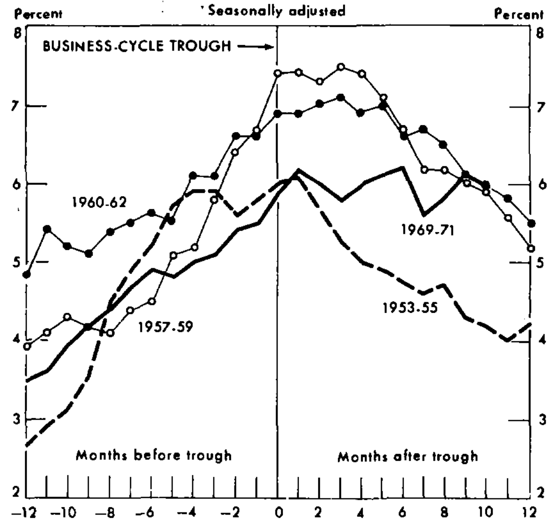
Note: The National Bureau of Economic Research has tentatively placed the peak and trough points of the recession at November 1969 and November 1970, respectively. Data for latest four months are subject to revision.
Source: Board of Governors of the Federal Reserve System.

of durable goods through August did not imply much improvement in the outlook for production. While there have recently been some erratic movements, total bookings were still being received at about the same pace as in the first quarter.

Conditions in the labor markets have fared little better than industrial production. In contrast to past recoveries, the expansion of payroll employment since the trough has been weak. In the November 1970-September 1971 period, total nonfarm employment rose by 900,000 compared with a 1.4 million advance in the ten-month period following the trough of the 1960-61 recession. Payroll employment registered a strong rise in September which accounted for one third of this recent ten-month gain. Moreover, the September increase included a sizable advance in manufacturing employment, where the sluggishness has been centered. Even with last month's rise, manufacturing employment is still only 86,000 above November 1970, a level fully 1.7 million below its July 1969 peak.

Chart III

UNEMPLOYMENT RATES 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: United States Department of Labor, Bureau of Statistics.

There has been no improvement in the overall unemployment rate during the recovery, contrary to the behavior in other post-Korean war upturns (see Chart III). Thus, in September the unemployment rate was still 6.0 percent, the same as the average rate prevailing since the November 1970 trough. The failure of the unemployment rate to decline cyclically was chiefly the result of the small advance in employment, since labor force growth from the November trough has on balance been slow. This increase would have been even smaller but for the effect on the civilian labor force of the ongoing cutbacks in armed forces personnel. Since June, unusual problems of seasonal adjustment have distorted the underlying pattern of civilian labor force growth, but it does appear that the rate of expansion has picked up in the past two months.