The Business Situation

Recent business statistics provide some favorable, though tentative, readings on the impact of the Administration's new economic policies. Price developments, particularly the September and October stability of industrial wholesale prices, attest to the effectiveness of the price freeze in that area. However, problems relating to survey techniques hampered efforts to assess the impact of the freeze on consumer prices, which recorded some increases in September. The rate of increase in compensation per man-hour in the private economy—the broadest measure of the behavior of wage costs—also slowed in the third quarter. The degree of this moderation was limited by the fact that these data only partially reflected developments during the wage freeze since it applied to only half the period.

The price freeze and the probable elimination of the excise tax on automobiles have given rise to a dramatic upswing in purchases of domestically produced automobiles. However, the overall pace of the business recovery remains on the sluggish side, as indicated by the relatively modest rise in real gross national product (GNP) in the third quarter. Part of this sluggishness stemmed from the depressing influence that the liquidation of excess steel stocks had on production and inventory spending. The reductions in personal income taxes and the establishment of the 7 percent investment tax credit that are now being considered by the Congress should help to strengthen the business recovery. While the recovery in production and employment has been particularly weak overall, the decline in the unemployment rate for the two most recent months to 5.8 percent in October is encouraging.

GROSS NATIONAL PRODUCT IN THE THIRD QUARTER

The market value of the nation's output of goods and services rose by $15.9 billion (see Chart I) to a seasonally adjusted annual rate of $1,059.0 billion in the third quarter. This gain, which amounted to about 6 percent at an annual rate, followed the 9 percent rise that occurred in the second quarter. After adjustment for changes in the price level, the July-to-September increment in real GNP was approximately 3 percent in contrast to the 5 percent increase in real output posted in the preceding three-month period. Thus, the third-quarter performance of real GNP—like most other recent business statistics—continued to point to a relatively sluggish recovery. It should be noted, however, that a sizable portion of the data used in compiling these preliminary GNP estimates reflected events which occurred prior to the President's announcement of the new economic policies.

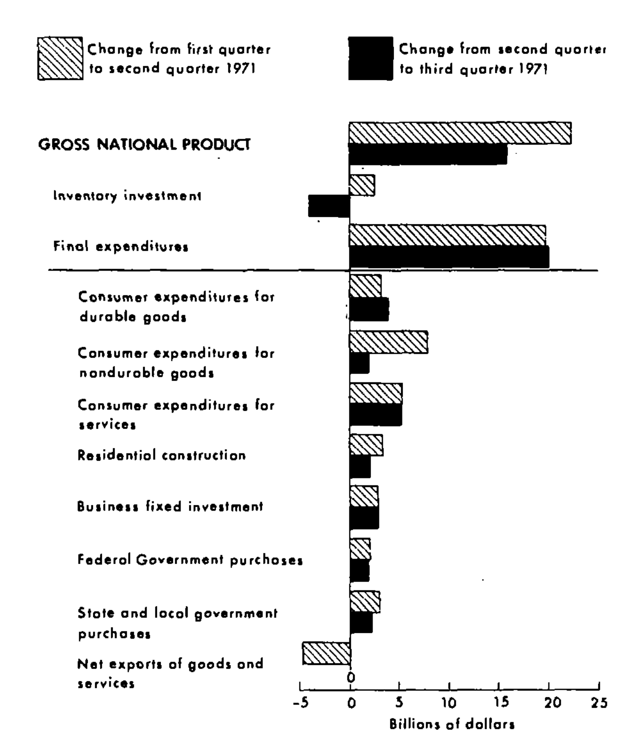
The slowing in the growth of nominal and real GNP was attributable to the reduced pace of inventory spending. According to preliminary estimates, inventory accumulation in the third quarter amounted to a modest $1.6 billion (annual rate), compared with the $5.7 billion rate in the April-June period, thus causing a $4 billion drag on the third-quarter rise in overall GNP. The pattern of inventory spending over the two most recent quarters was greatly distorted by the behavior of steel buying. In the April-June period, such spending was artificially increased by fears that the industry would be struck on August 1, whereas during the third quarter it was limited by the liquidation of a sizable part of those excess stocks. The drag on GNP arising from the inventory sector may be largely completed during the current quarter. In fact, with inventory-sales ratios in most sectors at comfortable levels, a more robust pace of inventory spending could become a major stimulus to the recovery once the overhang of excess steel inventories is worked off.

The third-quarter rise in final demand—i.e., GNP less inventory accumulation—amounted to $20 billion, a shade stronger than the increase posted over the April-June period. In real terms, final spending rose at a 4.7 percent annual rate. With the exception of the strike-distorted first quarter of 1971, this was the largest quarterly rise in real final demand in three years. The overall gain in final spending measured at prevailing prices was paced by relatively large increases in outlays for new residential

Chart I

RECENT CHANGES IN GROSS NATIONAL PRODUCT AND ITS COMPONENTS

Seasonally adjusted



Source: United States Department of Commerce.

construction and by a strong gain in business fixed investment spending, while consumer spending registered a moderate increase.

Business fixed investment advanced by $2.7 billion in the July-September period. This strength was somewhat surprising in light of the weakness in plant and equipment spending that has been indicated in most of the recent Government and private surveys of investment plans. In fact, over the two most recent quarters, business fixed investment spending has risen at an annual rate of about 10 percent. A sizable fraction of the overall strength in such investment during the third quarter reflected a stepped-up pace of business purchases of automobiles and trucks and, to a far less extent, a higher level of spending for farm equipment. In part, the strong showing of business spending on autos and trucks may have been spurred by the price freeze, which provided an incentive to purchase these goods while the freeze was in effect to avoid future price increases. Similarly, the pending elimination of the excise tax on automobiles and small trucks may also have contributed to this higher level of spending.

Given the role that autos and trucks played in the third-quarter rise in business fixed investment, the strength in this spending component was not indicative of a turnaround in spending for new plant and equipment, where the general outlook remains weak because of the sizable amount of unutilized capacity that currently exists. The rate of capacity utilization in manufacturing actually decreased in the third quarter of 1971 and was below that which prevailed in the last quarter of 1970—the tentatively designated trough of the business cycle—despite the depressing impact of the auto strike on fourth-quarter production. The failure of the rate of capacity utilization to rise substantially by this stage of the business recovery contrasts sharply with the experience of the other post-Korean war recoveries (see Chart II). The current sizable volume of excess capacity will most likely dampen the near-term impact of the probable reestablishment of a 7 percent investment tax credit. Indeed, the recent McGraw-Hill survey of spending plans suggests that neither this credit nor the earlier liberalization of depreciation allowances has caused much step-up in investment plans.

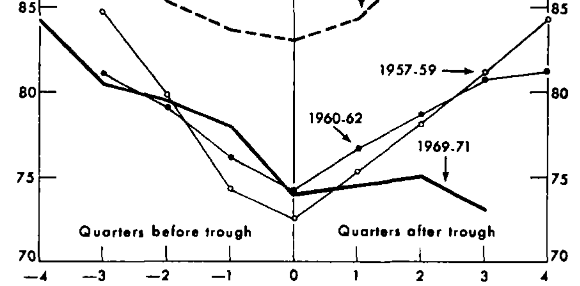
Spending on residential construction continued its strong upward momentum in the third quarter, rising by $2 billion to a seasonally adjusted annual rate of $41.7 billion. While this was somewhat smaller than the gain posted in each of the previous three quarters, it brought the overall rise of home-building outlays since the third quarter of 1970 to a very sizable 45 percent. The prospects for continued strength in outlays for residential construction appear good. In particular, the substantial declines in long-term interest rates that have occurred since the President's August 15 speech should have a favorable impact on the availability and cost of mortgage credit.

Personal consumption expenditures rose $11.2 billion in the third quarter to a seasonally adjusted annual rate of $672.1 billion, about $5 billion less than the gain recorded in the previous quarter. All of this shortfall occurred in purchases of nondurable goods; in contrast, consumer spending on durables accelerated in the third quarter, rising by about $4 billion. With the exception of the strike-distorted first quarter of 1971, this was the largest quarterly gain since the third quarter of 1968. A sharp spurt in automobile buying after the President's August 15 speech was the major reason for the overall strength in durables spending during the quarter. Indeed, aided by the price freeze and by the probable elimination of the 7 percent excise tax, sales of domestically produced cars rose markedly in the last half of the quarter, averaging a seasonally adjusted annual rate of better than 9 million units. Moreover, this surge continued into the current quarter, as sales of domestically produced cars ran at a seasonally adjusted annual rate of 10 million units in October. The decline in sales of imported cars from an annual rate of 1.8 million units in June to 1.3 million units in October apparently stemmed from the limited availability of imported vehicles that resulted from the longshoremen's strikes. Thus, the data which are currently available do not provide much guidance on the extent to which the import surtax and recent movements in exchange rates may have resulted in an increase in the demand for domestic cars at the expense of imports.

Despite the slower advance in consumption spending in the third quarter, the personal savings rate (the proportion of disposable income that is not spent) dropped by a relatively large 0.5 percentage point to 7.7 percent—a figure which is still very high by historical standards. The decline in the rate reflected the fact that the growth in personal income and disposable income diminished in the quarter.[*] In turn, the slower growth in personal income occurred partly because the second-quarter rise had been inflated by a lump-sum retroactive social security benefit increase. The third-quarter gain in personal income may have also been limited by the wage freeze, although the precise impact of the freeze is difficult to ascertain. In the near term, however, disposable income will receive additional stimulus from the large military pay boost which will occur in the current quarter and from a series of personal tax reductions recommended by the President and now being considered by the Congress. This additional stimulus to disposable income may well help to trigger a still more expansionary pace of consumer spending.

Chart II

CAPACITY UTILIZATION IN MANUFACTURING IN FOUR 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.

Government purchases of goods and services rose by $4.2 billion in the third quarter, as Federal spending increased by $1.9 billion while outlays by state and local governments posted a gain of $2.3 billion. The July-September increment in state and local spending was relatively small by recent standards. This resulted from a slower rise in employee compensation—probably due in part to the wage freeze—and a weakening in expenditures on new construction.

Net exports of goods and services, according to preliminary and incomplete data, were in deficit by $0.5 billion for the second consecutive quarter. Although these data may prove to be particularly unreliable because of the distortions arising from dock strikes, the recent behavior of the trade account does show a significant rise in the rate at which the United States economy is consuming imported goods. Indeed, spurred in part by the automobile strike and the threat of a steel strike, imports have risen by $9.3 billion over the four quarters that ended in September 1971. In contrast, over the similar period terminating in September 1970, the rise in imports was only $4.2 billion.

PRICES, PRODUCTIVITY, AND WAGES

During the third quarter, the implicit GNP deflator, which is the most comprehensive measure of price trends in the economy, rose at a 3.3 percent annual rate. This compares with the 4.0 percent rate of advance in the preceding quarter and represents the smallest rise since the second quarter of 1967. Since many of the underlying price data included in the deflator did not start to capture the effects of the freeze until September, comparatively little of the post-August 15 price developments show up in the average level of the deflator for the third quarter.

The deflator relies heavily, but not exclusively, on monthly wholesale and consumer price data. Although the freeze went into effect on August 15, the wholesale price data for that month describe almost entirely prefreeze developments because of the timing of the survey week. In September, wholesale prices actually eased on a seasonally adjusted basis, with prices of industrial commodities declining at a 1 percent annual rate after having risen at a 5 percent rate over the first eight months of 1971. In October, industrial prices again declined on a seasonally adjusted basis while agricultural prices rebounded. With the price freeze, however, normal seasonal adjustment procedures may be inappropriate. Thus, it is worth noting that without seasonal adjustment both the industrial and agricultural indexes were unchanged from their September levels.

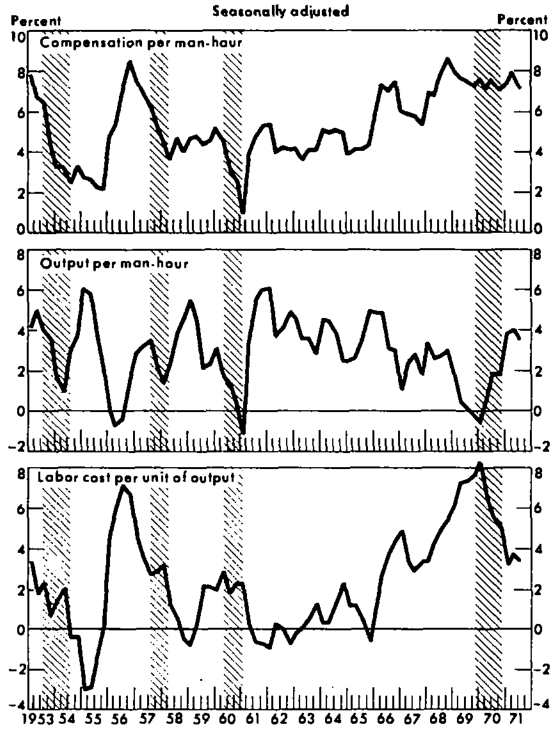
The effects of the freeze on consumer prices were not so evident as in the wholesale area. The August consumer price index, which seems to have largely captured pre-freeze price movements, rose at a 5 percent rate. In contrast to the dramatic reversal of wholesale price movements during September, consumer prices rose at a still sizable 2.4 percent annual rate in that month. The September consumer price increases, which were not available in time to be incorporated into the third-quarter GNP deflator estimate, stemmed from a variety of sources. Since not all components in the consumer price index are priced each month, part of the September increase may have reflected higher prices on items which were included in the September survey but had actually risen in price prior to August 15. The September rise in the consumer index also included higher prices for certain items not covered by the freeze, such as college tuition, taxes, mortgage interest rates, and certain import prices.

Chart III

LABOR COMPENSATION, PRODUCTIVITY, AND UNIT LABOR COST IN THE PRIVATE ECONOMY

CHANGE FROM FOUR QUARTERS EARLIER

Seasonally adjusted



Note: Shaded areas represent recession periods, according to the National Bureau of Economic Research chronology.

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

In contrast to the deceleration observed in the rate of price increase for most of the major GNP components, the deflator for nonresidential structures soared at a 21 percent annual rate in the third quarter while that for residential structures climbed at a 14 percent rate. These two price groupings were responsible for about 1 percentage point of the 3.3 percent rise in the overall GNP deflator. While the structures deflators tend to be quite volatile on a quarterly basis, these third-quarter advances may be mirroring the rapid run-up over the first eight months of the year in construction labor costs and in building materials prices. In turn, the run-up in building materials prices may be primarily a result of the very rapid increases in demand and sustained high levels of activity in the area of residential construction. It is pressure for price increases of this type that will provide Phase Two with some of its greatest challenges.

In previous business cycles, the behavior of unit labor costs was a major factor in achieving price stability (see Chart III). The cyclical pattern of declining unit labor costs chiefly resulted from the pickup in productivity growth that accompanied the recovery in production. In the past year and a half, the rate of increase in unit labor costs has slowed considerably. In the third quarter, however, this trend was obscured by unusual developments. On the one hand, agricultural output increased sharply, mainly reflecting a bumper corn crop. On the other hand, manufacturing productivity actually fell, primarily because of cutbacks among highly productive steelworkers.

The third-quarter data on major collective bargaining settlements underscore the severity of the inflationary pressures plaguing the economy. Based on preliminary data, the mean negotiated increase in wages and benefits during the third quarter was about 8½ percent over the life of the contract—essentially the same as for the first half of the year and only slightly below the 1970 rate of 9 percent. Almost all the major contracts expiring in the third quarter had been negotiated by August 15.