The Business Situation

The progress of the economic recovery from last year's recession continues to be mixed. A year after the cyclical trough, tentatively placed in November 1970, production and employment remain sluggish by comparison with the gains experienced in earlier recovery periods. Indeed, the unemployment rate again inched up to 6.0 percent in November, as a rise in employment was swamped by a large increase in the civilian labor force. There have been some indications in recent months, however, that the momentum of the recovery may be quickening. The level of gross national product (GNP) in the third quarter has been revised upward by $1.8 billion from the preliminary estimate.[1] Retail sales rose strongly over recent months. Moreover, these gains were widely based and not confined to automotive demand, which had risen markedly in part as a result of the proposed elimination of the automobile excise tax. After allowance for the rundown of inventory stocks accumulated in anticipation of a midsummer steel strike, manufacturers' demand for inventories appears to have strengthened. Residential construction activity remains high and, according to recent surveys, plant and equipment spending is slated to accelerate somewhat over this year's lethargic pace.

The impact of the ninety-day price freeze, which ended on November 13, is most clearly apparent in the data on wholesale prices. Indeed, wholesale industrial prices actually declined slightly over the three months that ended in November. The response of consumer prices was less dramatic, although technical factors complicate an assessment of the precise impact of the freeze on consumer prices. Looking to the future, price developments will depend in part on the manner in which the wage and price norms that were announced in November are applied. The newly established Pay Board and Price Commission have announced goals of holding overall increases in wages and benefits to 5.5 percent and in prices to 2.5 percent annually. The achievement of these goals in 1972 would represent significant progress in the fight against inflation.

INDUSTRIAL PRODUCTION, ORDERS, AND INVENTORIES

The Federal Reserve Board's index of industrial production inched up a scant 0.2 percent in October on a seasonally adjusted basis. The increase in the overall index was held down by a sharp drop in the output of coal that resulted from the coal miners' strike. Indeed, excluding the impact of that strike, the rise in industrial output was relatively strong, as gains in production in other industries were broadly based. Output of steel, copper, industrial and commercial equipment, and consumer goods increased. On the other hand, output of defense equipment and some nondurable materials declined. By October, total industrial production had risen 3.6 percent above the November 1970 low but was still 0.8 percent below the 1971 high reached in June and 5.0 percent below the record peak attained in September 1969.

The flow of new orders received by durable goods manufacturers rose modestly in October on a seasonally adjusted basis. In fact, the series has been essentially flat all year. Although, in the past, movements in new orders have often foreshadowed changes in economic activity, recent developments may have affected the usefulness of this series as a forecasting tool. For example, confronted with the price freeze and the uncertainties surrounding Phase Two policies which were being formulated during

[1] The revised third-quarter estimate indicates that GNP increased by $17.7 billion to a seasonally adjusted annual rate of $1,060.8 billion. The rate of increase in the implicit GNP price deflator was revised downward slightly to an annual rate of 3.0 percent. The revised estimates indicate greater growth in real GNP—3.9 percent rather than 2.8 percent as originally reported. Among the major contributors to the upward revision in current-dollar GNP were residential construction and net exports. On the other hand, the initially reported small rise in business inventories was revised down by $0.5 billion to a $1.1 billion increase from the second quarter. The preliminary estimates of corporate profits, released along with the GNP revisions, reveal that after-tax corporate profits slipped $0.2 billion during the third quarter to $45.8 billion at a seasonally adjusted annual rate.

October, buyers and sellers may have been reluctant to make firm commitments. Nevertheless, new orders in the critical producers' capital goods sector rose in October to a record $6.9 billion, according to preliminary figures.

Recent movements in manufacturers' inventories have been dominated by the rundown in steel stocks built up by users in anticipation of a midsummer steel strike. Thus, manufacturers' inventories of materials and supplies—measured on a seasonally adjusted book-value basis—declined by nearly $0.5 billion between August and October, with much of this decline reflecting the liquidation of excess steel stocks. Apart from materials and supplies, however, inventory demand of manufacturers has strengthened. These firms' inventories of finished goods and goods in process increased by $1.0 billion between August and October. According to the results of a recent Government survey, moreover, manufacturers plan to expand their inventories further over the balance of the year. Increased inventory accumulation could well augment stronger final demand in spurring economic activity in coming months. This would be a major propellant for faster economic growth, since the sluggishness of inventory spending has been one of the most important factors in the slower than usual pace of the recovery.

The strengthening in demand for inventories appears to have extended to wholesale and retail trade establishments as well. The book value of wholesale and retail trade inventories rose by a substantial $0.6 billion in September (the latest month for which data are available). During the third quarter, total trade inventories increased at a seasonally adjusted rate of $1.9 billion, up about $0.4 billion from the previous quarter. At the same time, inventories at retail automotive outlets declined slightly. For the most part the accumulations were about in line with sales, and inventory-sales ratios remained at comfortable levels.

PLANNED INVESTMENT SPENDING

According to several surveys taken after President Nixon outlined the new economic program on August 15, businesses plan to step up their fixed investment outlays in 1972. In a survey taken jointly by the Department of Commerce and the Securities and Exchange Commission in October and November, plant and equipment expenditures during the first half of 1972 were projected to rise 9.1 percent above what they had been in the comparable period of 1971. This estimated increase is consistent with the results of private surveys covering the entire year. The McGraw-Hill survey reported a 7 percent planned rise in plant and equipment expenditures during the upcoming year, slightly exceeding the 5 percent increase in capital goods' prices anticipated by the respondents to the survey. In comparison, the results of the earlier Lionel D. Edie and Co. survey indicated that businesses plan to spend 9 percent more on fixed investment goods while expecting capital goods' prices to rise 4.5 percent.

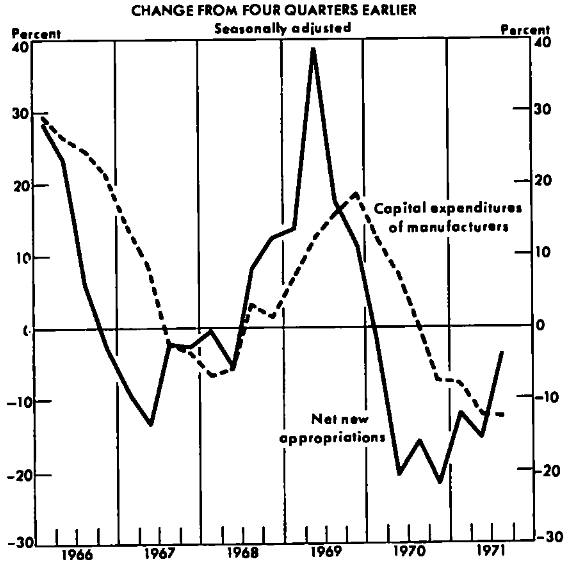
Although there are differences among the survey results in some details, the surveys are in broad agreement over the projected course of manufacturers' expenditures for plant and equipment. Whereas this spending component has been distinctly sluggish in 1970 and 1971, all three surveys foresee a substantial rise during the next few months. Of course, how much of this planned spending actually materializes will depend on how closely unfolding economic developments match current business projections. One early sign that a pickup in manufacturers' capital spending may be in the offing is the third-quarter turnabout in capital appropriations made by manufacturers (see Chart I). After falling in the previous quarter, net new appropriations increased some 14 percent in the third quarter according to a Conference Board survey. While the volatility of this series argues against attaching too much significance to short-run movements, the increase is consistent with the outlook for manufacturers' plant and equipment spending provided in the other surveys.

Chart I

MANUFACTURERS' EXPENDITURES AND APPROPRIATIONS FOR NEW PLANT AND EQUIPMENT

CHANGE FROM FOUR QUARTERS EARLIER

Seasonally adjusted



Source: The Conference Board, Inc.

RESIDENTIAL CONSTRUCTION

Residential construction activity has continued to be a source of considerable economic strength. After dipping in September, housing starts in October again edged above the 2 million mark on a seasonally adjusted annual rate basis—a shade below the record third-quarter average of 2.1 million units. At the same time, newly issued building permits jumped nearly 17 percent in October to a seasonally adjusted annual rate of 2.2 million units, an all-time record. Since newly issued permits again exceeded the number of housing starts, the backlog of units yet to be begun rose in October, continuing its almost steady growth of the past year or so.

The course of residential home building during coming months will depend to some extent on developments in the mortgage market. Since in most instances mortgage commitments must be secured before construction financing can be arranged, the commitments series serves as an advance indicator of construction activity (see Chart II). In the third quarter, outstanding commitments of savings and loan associations and mutual savings banks had risen to record levels on a nonseasonally adjusted basis. Moreover, according to most indicators, conditions in the mortgage market have eased since then. It is true that the average interest cost of conventional mortgages edged higher in September before leveling off in October. However, these data are based on mortgage closings and thus reflect market conditions as much as several months earlier when the commitments were made. The more sensitive secondary market yields of Federal Housing Administration-insured loans declined in both September and October. A major factor underlying this easing in the mortgage market appears to have been the relatively large declines in interest rates on corporate bonds and United States Government securities. For example, the interest rate spread of conventional mortgages over Government securities with a maturity of ten years or more increased almost 60 basis points between June and October, while the spread between secondary FHA mortgages and long-term Government securities rose 34 basis points. Earlier in the year, when interest rates on these instruments were high relative to those on mortgages, savings and loan associations and mutual savings banks had used portions of their sizable savings inflows to acquire bonds and, in particular, to rebuild their liquidity positions. Recently, however, they have begun to channel proportionately more of their inflows to the mortgage market.

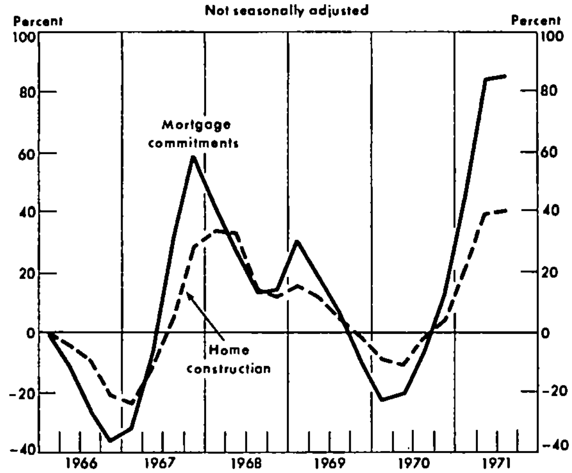
The expanded presence of the Federal Government in the private housing sector has contributed importantly to the 1971 housing boom. During the current year, the number of private housing starts receiving either a direct or indirect Federal subsidy is estimated at about ½ million units. It is unlikely that the number of subsidized starts will decline next year, especially in view of the Government's strong commitment to upgrade and enlarge the stock of residential housing.

Chart II

MORTGAGE COMMITMENTS AND RESIDENTIAL CONSTRUCTION EXPENDITURES

CHANGE FROM FOUR QUARTERS EARLIER

Not seasonally adjusted



Sources: Federal Home Loan Bank Board; Savings Bank Association of New York State; United States Department of Commerce, Bureau of the Census.

INCOME, CONSUMPTION, AND EMPLOYMENT

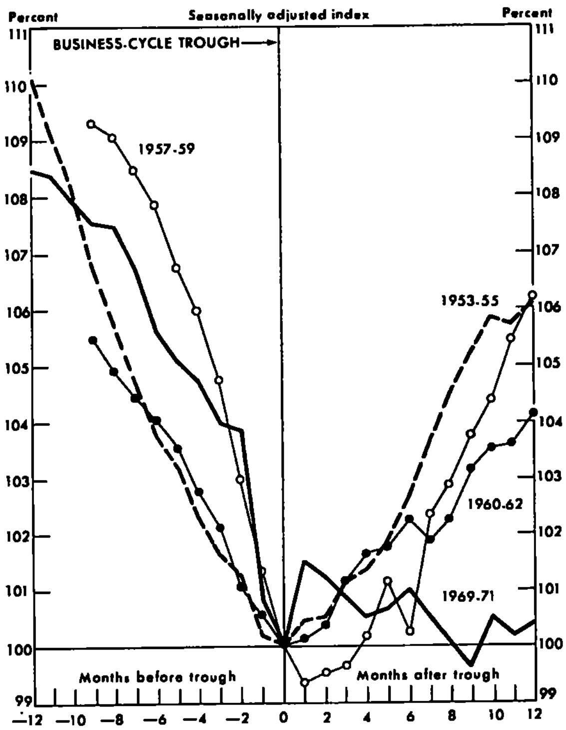
Compared with the \$5.1 billion monthly average increase in personal income so far this year, the \$0.8 billion rise in October was minuscule. The increase was more than accounted for by a \$1.3 billion increment in wage and salary disbursements—this too being well below the average growth of previous months. With wages frozen and payroll employment practically unchanged in October, the increase in wage and salary disbursements probably stemmed largely from the longer workweek and increased overtime during the month.

Recent retail sales data support the view that consumers have become somewhat less hesitant. During the five months that ended in October, nonautomotive retail sales increased at a seasonally adjusted annual rate of 8.3 percent. In comparison, over the first five months of the year, nonautomotive sales had grown at an annual rate of only 3.5 percent. In view of the slowing in the rate of increase of consumer goods prices, the recent accelerated growth in nonautomotive retail sales is all the more significant. After surging dramatically in August and September, the automotive component of retail sales fell slightly in October, according to preliminary estimates. This decline may reflect seasonal adjustment difficulties associated with the price freeze, inasmuch as unit sales of new domestically produced passenger cars were reported to have risen almost 8 percent in October. During the three months ended in November, these sales were running at a seasonally adjusted annual rate of 9.8 million units, an increase of nearly 17 percent over average sales in the earlier months of 1971. Another indication of growing confidence on the part of consumers can be seen in their willingness to increase their indebtedness. The average monthly increase in consumer credit over the five-month period ended in October was nearly double that of the first five months of the year.

To some extent, the apparent shoring-up of consumers' confidence may be anchored in labor market conditions, which have begun to show some—admittedly scattered—improvements during recent months. After being virtually unchanged during the first six months of 1971, civilian employment posted a substantial gain of 520,000 on average in the third quarter, matched by an almost equal gain in the first two months of the current quarter. At the same time, however, this employment growth has been largely counterbalanced by an unusually big rise in the civilian labor force, leaving the unemployment rate hovering at 6.0 percent.

Some tentative improvements in labor market conditions can also be seen in the recent payroll survey data. After remaining virtually flat during the first eight months of the year, nonagricultural payroll employment increased about 390,000 on a seasonally adjusted basis between August and November. The extent of the advance was held down by the coal miners' and East and Gulf Coast dock workers' strikes, which were still in progress at the time of the November survey. In the manufacturing sector, the number of workers employed rose by 130,000 from August to November. Part of this gain was accounted for by the return of some steelworkers who had been laid off in August after the threatened steel strike was averted. Taking a longer perspective, the relatively slow pace of the recovery from last year's recession is clearly evident in manufacturing employment. During the year after the tentatively identified recession trough of November 1970, employment in manufacturing increased by only 0.4 percent (see Chart III). In contrast, such employment had posted gains ranging from 4.1 percent to 6.2 percent in the three earlier post-Korean war recoveries.

Chart III
MANUFACTURING EMPLOYMENT 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: United States Department of Labor, Bureau of Labor Statistics.

PRICE DEVELOPMENTS

The special circumstances surrounding the ninety-day price freeze that ended on November 13 have made recent movements in the consumer price index difficult to assess. For example, prices of some commodities and services were exempt from the freeze. Moreover, some items covered in the consumer price index are priced less frequently than monthly so that numerous price changes are reflected in the index with a lag. Even the practice of seasonal adjustment may produce misleading results when the customary seasonal variations are not fully permitted. With this in mind, the latest available data indicate that consumer prices rose at a seasonally adjusted annual rate of 1.6 percent in October, the smallest advance since April 1967. On an unadjusted basis the index rose at a 2 percent annual rate in October, the same as in the preceding month. The rate of increase in prices of nonfood commodities (not seasonally adjusted) was a large 5.1 percent in October, the same as in the preceding month, and primarily reflected higher prices for apparel and new cars, including imports.

The price freeze apparently had a much greater effect on wholesale prices than on consumer prices. After rising sharply over the first eight months of 1971, wholesale prices actually declined slightly between August and November. While prices of agricultural products which were not subject to the freeze fluctuated widely, industrial wholesale prices generally edged lower. These prices fell at a seasonally adjusted annual rate of 1.3 percent between August and November, following their large increase at an annual rate of 5.0 percent earlier in the year. On an unadjusted basis, industrial wholesale prices fell at an annual rate of 0.7 percent between August and November.