The Business Situation

Recent business indicators confirm that some acceleration of the economic recovery occurred toward the end of 1971 following a lethargic showing over most of the year. In the fourth quarter, real gross national product (GNP) advanced at a 6 percent annual rate, about double the very sluggish rate of increase in the two preceding quarters. Similarly, the tempo of industrial production quickened somewhat toward the year-end. There are some signs that the recently increased economic momentum may be carrying into 1972. The record levels of housing starts and building permits in December increased the likelihood that the housing boom will continue into the opening months of the year, while the latest surveys of plant and equipment spending intentions for 1972 suggest that a strengthening of recently weak business investment could emerge this year. On the other hand, post-freeze developments in retail sales, together with the continued high rate of personal savings, provide no clear indication that consumers have overcome their hesitancy. However, the net tax reductions for most income groups that took effect in January should help to bolster consumer demand. As yet, the improved pace of the recovery has not had a significant influence on the unemployment rate, although the rate slipped slightly in January.

The recent data on wages and prices—while showing some encouraging developments—do not yet provide a firm foundation for evaluating the progress of Phase Two policies in combating inflation. To be sure, all of the major indexes of price and wage trends slowed markedly in the fourth quarter. Generally speaking, however, these data overstate the moderation in underlying inflation since they were heavily influenced by the mid-August to mid-November price and wage freeze. On the other hand, price data in the months immediately following the freeze may overstate inflationary trends as a result of the clustering of price and wage increases.

GROSS NATIONAL PRODUCT AND RELATED DEVELOPMENTS

During the fourth quarter of 1971, the market value of the nation's output of goods and services rose by $19.6 billion (see Chart I) to a seasonally adjusted annual rate of $1,073.0 billion. The rise in real GNP—that is, GNP adjusted for price increases—was at a rapid 6.1 percent annual rate, the largest advance in more than three years except for the first quarter of 1971 which was swollen by the rebound from the General Motors strike. At the same time, the GNP price deflator rose at an annual rate of only 1.5 percent, the smallest since the beginning of the Vietnam escalation.

On the basis of newly revised data, real GNP growth during the second and third quarters of last year is now reported to have averaged a 3 percent annual rate, about 1 percentage point less than previously estimated. Normally, such revisions of the GNP data are not published until July of the following year. However, the need to adjust certain GNP components for retroactive provisions of the Revenue Act of 1971, together with some major revisions of the source data used to estimate GNP, prompted these earlier than usual revisions in the GNP accounts. One effect of these changes was to underscore even more forcefully the sluggishness of the economic recovery during most of 1971 and to make the fourth-quarter performance stand out in sharper contrast.

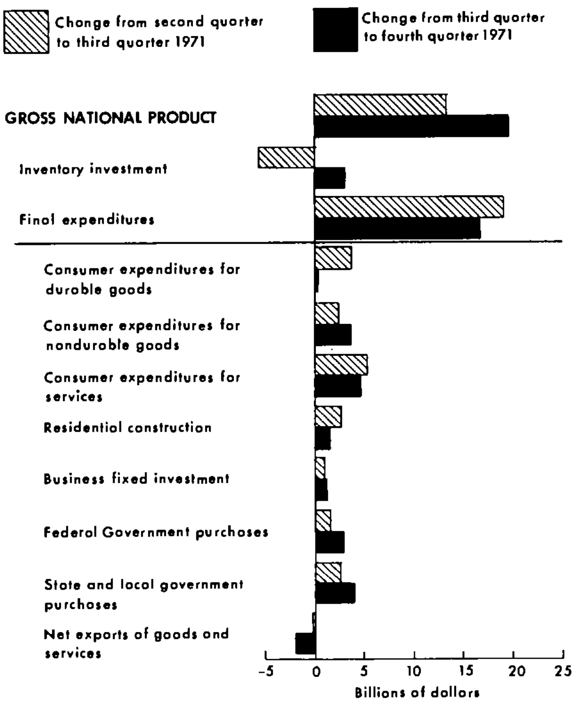
The fourth-quarter strengthening in the growth of GNP was partially a result of greater inventory spending. In the previous quarter, inventory spending as measured in the GNP accounts had actually declined, as users worked off excess steel inventories that had been accumulated earlier as a hedge against a possible strike. While the steel adjustment continued into the fourth quarter—as suggested by the virtually unchanged level of durables manufacturers' inventories on a book-value basis during November and December—the magnitude of the resulting drag on overall inventory spending was smaller than in the third quarter. More importantly, however, there was also some evidence of a strengthening in the underlying demand for inventories during the final months of the year. In part, this may have reflected the general improvement in confidence that appeared to characterize this period. Beyond this, the relatively low level of inventory-sales ratios in most sectors was conducive to higher demands for stocks. These factors, especially if coupled with an acceleration of final sales, should lead to a still more expansionary rate of inventory spending in the months ahead which in turn would tend to stimulate production and employment.

The most recent readings of the Federal Reserve Board's index of industrial production provide some evidence of a quickening in the pace of industrial output. Indeed, increases in November and December industrial production averaged a fairly substantial 0.7 percent. While part of these gains resulted from the resumption of coal production following the coal miners' strike, the advances in output excluding coal were still fairly sizable. Moreover, these most recent gains in production were broadly based, as December production levels in virtually every major grouping were above their October readings. One major exception to this rule was the production of motor vehicles and parts which stood at 0.4 percent below its October level.

Chart I

RECENT CHANGES IN GROSS NATIONAL PRODUCT AND ITS COMPONENTS

Seasonally adjusted



Source: United States Department of Commerce.

The failure of automobile production to show added strength at the year-end may have been a reflection of the sharp downturn in sales of domestically produced cars that occurred in December. Indeed, new car sales, which surged almost immediately after the President's August 15 speech and continued at a rapid rate into the fourth quarter, dropped off during late November and in December. This suggests that at least some of the spurt in purchases represented buyer attempts to avoid higher future car prices. Increases were, in fact, allowed by the Price Commission after the end of the freeze. Sales of imported automobiles have tended to weaken since cresting in mid-1971, but it is impossible to determine how much of this was the consequence of shortages resulting from longshoremen labor disputes as distinct from the higher import prices stemming from the temporary import surcharge and from the international currency realignments.

The end-of-quarter weakening in automobile sales was one factor that held the fourth-quarter rise in consumer spending to a modest $8.9 billion, a somewhat smaller gain than was registered in the two preceding quarters. Because of the dramatic impact of the freeze on the rate of inflation, however, the October-December quarter's gain in real consumption amounted to a 4 percent annual rate, the same as in the second and third quarters. In addition to the December slowdown in auto sales, nonautomotive retail sales closed the year on a somewhat weak note. On the other hand, consumer credit outstanding continued to grow quite rapidly in the final months of 1971. The increased willingness of consumers to finance purchases through credit may be an indication of an improvement in consumer confidence. In any event, the outlook for consumer spending has been enhanced by the net tax reductions for most income groups which took effect in January of this year.

Despite the moderate advance in current-dollar consumption spending in the fourth quarter, the ratio of personal savings to disposable or after-tax income fell by 0.4 percentage point to 7.7 percent. This decline in the savings rate was primarily a reflection of accelerated collections procedures for estate and gift taxes, which temporarily increased personal tax payments by about $3 billion in the fourth quarter and thereby depressed the level of disposable income. However, since this change in collections procedures was not likely to have had a major impact on consumer spending, it can be assumed to have been the principal cause of the reduced savings rate. And, even without allowance for this factor, the savings rate in the fourth quarter remained very high by historical standards.

Home-building activity continued to expand in the fourth quarter from the very high levels attained earlier in the year. Indeed, the monthly record for the level of seasonally adjusted housing starts was shattered by November's 2.3 million unit annual rate and again by December's 2.5 million units. Although the small December seasonal factor may have exaggerated the effect of exceptionally good weather, during the fourth quarter as a whole housing starts increased at a 22 percent annual rate over the level attained in the previous three-month period. At the same time, newly issued building permits, which are an advance indicator of home-building starts, climbed at about a 27 percent annual rate. In short, despite the record performance of the housing sector during 1971, indications are that this upward momentum may carry into the opening months of 1972. The recent declines in most market interest rates should further strengthen the competitive position of the nation's thrift institutions, thereby facilitating the continued ample flow of credit into the residential mortgage market.

The growth in business fixed investment expenditures was a modest $1.1 billion in the final quarter of 1971, about the same as in the previous three months. During the fourth quarter, and for the year as a whole, low levels of industrial capacity utilization as well as the sluggish pace of the recovery had a depressing impact on business fixed investment, particularly in the manufacturing sector. However, recent indications suggest that a more expansionary spending pace may emerge in 1972. For example, between June and December 1971, the index of industrial production for business equipment increased at an annual rate of 7.4 percent, reversing a two-year downward trend. Similarly, the most recent survey of capital spending plans conducted jointly by the Department of Commerce and the Securities and Exchange Commission indicates that such investment is expected to rise by about 9.1 percent in 1972, a figure which is roughly in line with other recent survey results. Manufacturing companies are expected to increase investment spending by 4 percent, a marked contrast to the 5.4 percent decline registered in 1971.

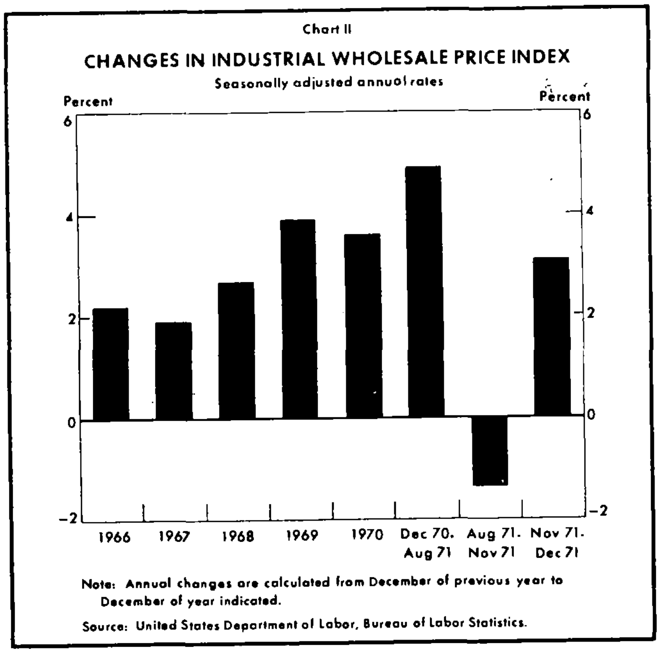
Government purchases of goods and services jumped by a very sizable $7 billion during the fourth quarter, or about three times the average quarterly gain in recent years. Increased spending by state and local governments accounted for $4 billion of this gain. Spending on structures, which had been particularly sluggish earlier in the year despite heavy state and local borrowing, rose sharply during the final quarter. At the Federal level, a military pay raise designed to help speed the transition to a volunteer army took effect in mid-November and accounted for about one third of the $3 billion rise in total Federal expenditures. A substantial increase in crop purchases under the price-support programs of the Commodity Credit Corporation was also a factor in the advance in Federal spending.

Net exports of goods and services posted a deficit of $2.0 billion in the fourth quarter, according to preliminary estimates. Since this account had been in balance during the preceding quarter, the fourth-quarter deficit represented a $2 billion drag on the overall advance of nominal GNP. The latest decline in net exports was primarily the result of the East and Gulf Coast dock strikes although, even apart from this factor, the trade position of the United States deteriorated sharply in 1971. In the future, however, the December 18, 1971 currency realignments and the ongoing trade negotiations should lead to an improvement in our position in the world markets, and thereby promote a strengthening in our net export position.

PRICES, WAGES, AND PRODUCTIVITY

Since August 15, a different framework has surrounded the making of price and wage decisions. Inflation rates slowed, in some cases quite dramatically, under the impact of the ninety-day wage and price freeze. While some rather sizable price and wage increases have taken place in the post-freeze period, a bunching of increases that might otherwise have been spread out over the three-month period of the freeze was to be expected. Under these circumstances, the advances recorded in the available price data for December and January have actually been smaller than might have been feared.

Some of the clearest manifestations of recent policy changes are to be found in the behavior of seasonally adjusted wholesale industrial prices (see Chart II). Over the first eight months of 1971, these prices soared at a 4.9 percent annual rate. They then declined at a 1.3 percent rate between August and November, and spurted at a 3.1 percent rate in December. Movements in consumer prices followed roughly similar contours, but the data collection procedures for consumer prices are such that not all prices for the items in the index are sampled every month. Thus, consumer price changes recorded during the freeze included some pre-New Economic Policy developments while changes recorded during the early stages of Phase Two are still a partial reflection of the freeze. The rise in consumer prices, which had proceeded at a 3.8 percent annual rate over the first eight months of last year, slowed to 1.7 percent during the freeze and then accelerated to a 4.6 percent annual rate of increase in December. The December rise in consumer prices was paced by a large increase in food prices, many of which had not been covered by the freeze. Nonfood commodity prices rose by a fairly substantial seasonally adjusted annual rate of 4.1 percent. However, because of the sampling procedures noted above,

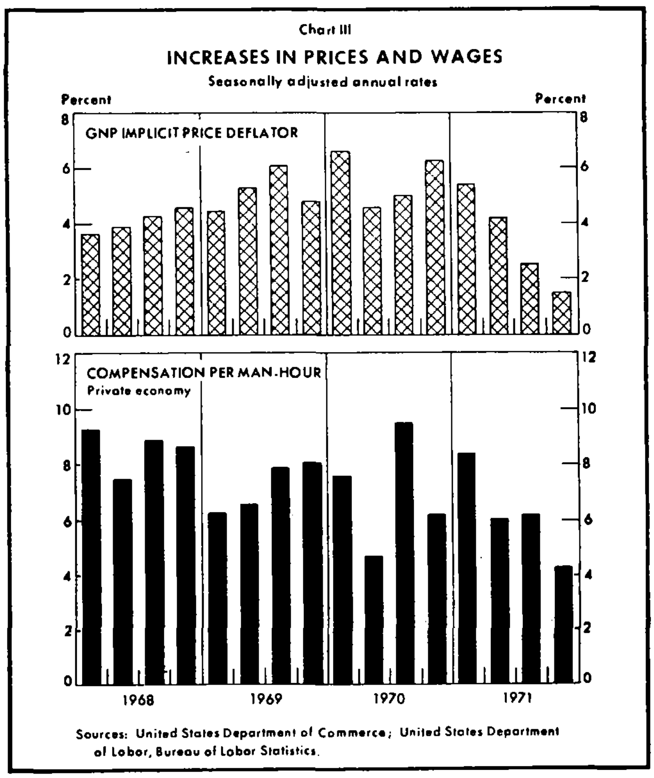


the December consumer price data probably did not fully capture the clustering of price increases that seems likely to have occurred following the termination of the freeze.

The implicit GNP deflator, which is the broadest available measure of price changes, rose at a relatively modest 1.5 percent annual rate during the fourth quarter (see Chart III). While this was the smallest such quarterly advance since 1965, the behavior of the deflator exaggerates the underlying moderation in inflation. For example, in the absence of the auto excise tax repeal, the deflator would have risen at an annual rate of about 2 percent. More importantly, because it is essentially an average of monthly price data during the quarter, most of the data used in estimating the deflator for the fourth quarter was collected while the freeze was still in effect. As a consequence, much of the post-freeze clustering of price increases will be reflected in the quarterly average level of the deflator for the first three months of 1972. Just as the deflator for the fourth quarter tends to understate the rate of inflation, its 1972 first-quarter showing will probably overstate the situation.

During the fourth quarter, the increase in compensation per man-hour in the private economy slowed to a 4.3 percent annual rate, a marked deceleration from the gains of 6 percent to 9 percent generally registered over the last several years. The fourth-quarter showing of compensation per man-hour was, however, also heavily influenced by the ninety-day freeze. Indeed, because compensation per man-hour is a measure of the quarterly average level of wage and benefit payments, most of the monthly data used to estimate it over the last three months of 1971 was collected while the freeze was still in effect. For example, between August and November, average hourly earnings—one of the monthly sources for the series on compensation per man-hour—rose at only a 2 percent annual rate. Reflecting the post-freeze clustering of wage increases, this series then shot up at an annual rate of 10 percent in December and a slower but still rapid 7 percent in January. This pattern of behavior suggests that the quarterly rise in compensation per man-hour—like most wage and price series—could accelerate at the start of 1972 as a large number of wage increases are concentrated into a relatively short time span.

Productivity, as measured by the index of output per man-hour in the private economy, rose at a 3.4 percent annual rate during the fourth quarter—slightly above its long-term trend. Excluding the farm sector, where productivity changes tend to be quite volatile on a quarterly basis, output per man-hour climbed at a 4.9 percent an-



nual rate in the final quarter, nearly twice as fast as in the preceding two quarters. As a consequence of the combined private economy compensation and productivity changes, labor costs per unit of output rose at a very small 0.7 percent annual rate, the slowest quarterly growth since 1965. However, because as noted earlier the rise in compensation was held down by the wage freeze, the increase in unit labor costs was similarly affected. Thus, these data do not provide a clear indication of the extent to which labor cost pressures on the price level have moderated.

Some very tentative signs of improved labor market conditions emerged from the surveys conducted by the Bureau of Labor Statistics during January. After strengthening in the closing months of last year, seasonally adjusted nonfarm payrolls rose by an additional 240,000 workers, the largest monthly gain since payroll employment bottomed out in November 1970. However, about one third of the overall January rise was concentrated in contract construction, possibly as a result of the exceptionally mild weather prevailing in some parts of the country during the month. The increase of 45,000 workers on manufacturing payrolls was accompanied by sizable declines in the average factory workweek and hours of overtime. According to the monthly household survey, the unemployment rate for January was a seasonally adjusted 5.9 percent. Although some of the data point to a firming of labor markets for experienced workers, the overall unemployment rate was probably not significantly changed from December's downward revised 6.0 percent.