The Business Situation

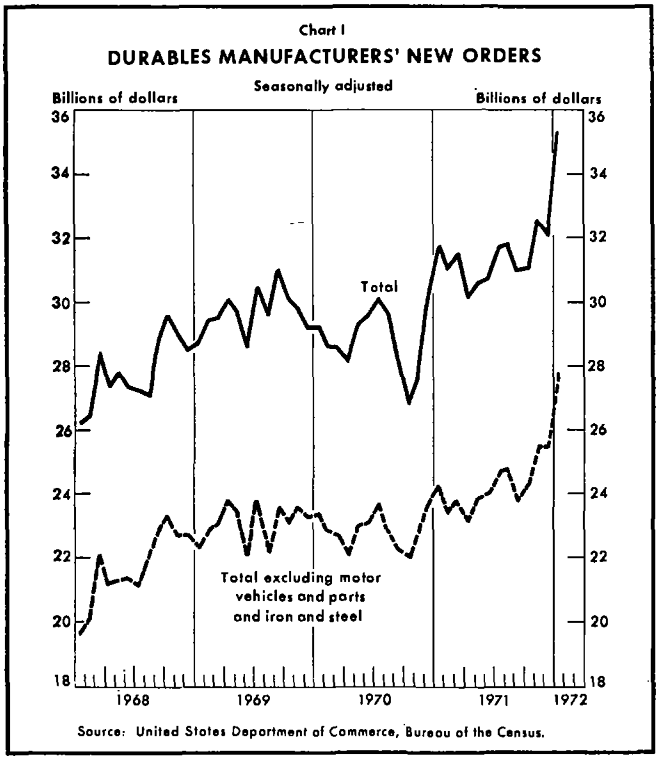
The economic data that have become available during the past few weeks suggest a continuation of the recent modest improvement in the uneven recovery from the 1969-70 recession.[1] Industrial production rose only slightly in January, but new orders for durable goods advanced strongly. Although part of the rise in orders was defense related, the overall quickening seemed broadly based. A number of recent surveys indicate strengthening of capital spending plans by businesses. Housing starts, moreover, rose again from the previous record level of December. In addition, personal income increased appreciably in January following an even larger gain in December. In part, these increases reflected higher Federal civilian and military pay scales as well as a clustering of wage increases after the end of the wage freeze. Eventually, the higher levels of personal income should help to stimulate consumer spending, which has shown little buoyancy since the wage-price freeze ended in November. During December and January, the first full months of Phase Two, the major price series have risen considerably faster than during the preceding ninety-day freeze. Some acceleration was, of course, to be expected as part of the transition to the more flexible form of inflation controls operative since mid-November. Tentative signs of gradually improving labor market conditions have also emerged since the middle of last year.

PRODUCTION, ORDERS, AND INVENTORIES

The Federal Reserve Board's index of industrial production rose in January by 0.3 percentage point to a level only 2.5 percent above the output of a year earlier and still 3.6 percent below the historic peak reached in the fall of 1969. Since last August, the index has risen at about a 6 percent annual rate, compared with a pace of only 1 percent over the earlier months of 1971. However, a significant part of this recent expansion reflected strike-related fluctuations in iron and steel production, which dropped sharply last August as businesses began working off the inventories stockpiled in anticipation of a strike. After rebounding in September, steel production moved somewhat unevenly over the balance of the year and rose again in January 1972 but still remained considerably below pre-August levels. In fact, without the increase in steel production, the overall production index would have remained essentially unchanged in January. Excluding the iron and steel sector, industrial production has increased at an annual rate of about 4 percent since last August, slightly faster than earlier in 1971.

The production of motor vehicles and parts declined in January, reflecting to some extent temporary reductions undertaken by automobile manufacturers to bring inventories into better alignment with the slower pace of sales that has prevailed since the end of the wage-price freeze. Output of business equipment was essentially unchanged in January. Indeed, after downward revisions for the last three months of 1971, business equipment output in January was only slightly above the level of last August, indicating a considerably weaker recovery in this sector than had been thought earlier. Output of durable goods as a whole was unchanged in January, maintaining the essentially flat pattern that had characterized most of 1971. In contrast, production of nondurable manufactured goods posted a sizable gain in January in a continuation of the rapid growth that had occurred during the latter part of 1971.

[1] In its revised figures for fourth-quarter 1971 gross national product (GNP), the Department of Commerce increased its estimate of inventory accumulation from \$1.9 billion to \$2.4 billion (seasonally adjusted annual rate). Fourth-quarter business fixed investment was also raised by \$2.2 billion, primarily through the \$1.8 billion upward revision of producers' durable equipment. Net exports of goods and services, on the other hand, fell by \$4.6 billion instead of the \$2.0 billion previously estimated. Since other components changed little, these compensating adjustments left total current-dollar GNP virtually unchanged at \$1,072.9 billion. The implicit price deflator is now estimated to have risen at a 1.7 percent annual rate rather than the 1.5 percent originally posted so that the fourth-quarter rate of real GNP growth is now placed at 5.8 percent, down slightly from the 6.1 percent initially estimated.



In January, new orders for durable goods increased by a very substantial 9.7 percent to a record $35.3 billion (see Chart I). In part, this bulge in orders resulted from an upsurge in orders of defense goods which accounted for about one third of the overall gain in bookings. However, even apart from the defense sector, the January data on durables orders suggested a broadly based strengthening in bookings inasmuch as most major industry groupings posted relatively large gains.

Although the new orders series for durable goods is quite volatile, the sharp January rise reinforces the view that this advance indicator of business activity has strengthened significantly in recent months. For example, during the four months ended in January 1972, the average level of durables bookings was more than 5 percent above the average that had prevailed over the first nine months of 1971. Excluding the volatile and strike-distorted steel and motor vehicle groups, the strengthening in orders was slightly more pronounced. Of particular note was the sharp rise in capital goods orders over this period, even after allowing for the fact that some defense bookings are counted as orders for producers' capital goods. This gain in bookings suggests some future quickening in business spending on capital goods. Such an outcome would be consistent with the results of recent surveys of plant and equipment spending intentions.

Government and private surveys are in close agreement that business capital spending will serve as a source of substantial economic stimulation during 1972, following the very small growth in 1971. For example, a McGraw-Hill study conducted in January and February of this year indicated that firms were planning to raise their outlays by more than 11 percent in 1972. This represents an upward revision of investment plans since last fall, when the same group of respondents had indicated plans to raise capital spending by only 7 percent in 1972. Similarly, the latest study conducted by Lionel D. Edie and Co. points to a 1972 rise of 12 percent, up from an earlier estimate of 9 percent. As a result of its January-February survey, the Commerce Department's latest estimate is for a 10½ percent climb in business plant and equipment spending, an improvement over the 9 percent rise previously projected for 1972. By comparison, the Commerce Department also estimates that plant and equipment outlays edged up by less than 2 percent last year, the smallest yearly gain since 1961, when expenditures declined by about 2 percent. During the fourth quarter of 1971, capital appropriations of the 1,000 largest manufacturing firms declined after rising sharply in the previous quarter, according to a Conference Board survey. However, capital appropriations of firms outside the petroleum industry rose slightly in the fourth quarter. Moreover, the recent surveys of investment plans point to an encouraging climb in capital outlays by manufacturers. For example, the Commerce Department survey indicates a 1972 rise of almost 9 percent in manufacturers' plant and equipment spending, which would represent a dramatic turnaround from last year's 6.1 percent decline.

During January, total manufacturers' shipments posted a large gain of $2.4 billion, four fifths of which was concentrated in the durables sector. While higher shipments of motor vehicles and parts accounted for a large part of the overall rise in durable goods shipments, most other industry and market groupings also posted sizable gains. Concurrent with the large January increase in shipments, total manufacturers' inventories rose by a modest $0.2 billion. Thus, the inventory-sales ratio declined sharply, reaching its lowest level since 1966. The pronounced drop in the inventory-sales ratio increases the likelihood of additional strengthening in both production and inventory spending in the months ahead.

CONSUMER DEMAND AND PERSONAL INCOME

Although monthly estimates of retail sales are volatile and subject to large revisions, recent data suggest that the pace of consumer spending has moderated. After cresting in November, seasonally adjusted retail sales declined in December and, according to advance estimates, showed little change in January. An important factor in the behavior of consumer spending at retail outlets has been the varying pace of new car sales in recent months. Over the first eight months of 1971, unit sales of domestically produced autos held relatively steady, averaging an 8.4 million unit annual rate on a seasonally adjusted basis. In the September-through-November period roughly corresponding to the price freeze, the annual rate of sales soared to 9.8 million units. After the end of the freeze there was a sharp dip in automobile sales, suggesting that some buyers had rushed out to purchase automobiles on the expectation, which proved correct, that prices would be permitted to rise. In December, sales slumped to a 7.8 million unit annual rate. Subsequently, automobile sales have strengthened, totaling a seasonally adjusted annual rate of 8.6 million units in January and 8.7 million in February.

Recent rapid growth in personal income should provide some impetus to spending by consumers. Following the December rise of $9 billion, which was one of the largest gains on record, personal income rose by a sizable $7 billion in January to a seasonally adjusted annual rate of $891 billion. By comparison, the average monthly increase for the twelve months ended in November 1971 was about $5 billion. The huge December gain resulted from several factors, including the military pay raise and the payment to teachers of some retroactive salary increases held up by the freeze. There was also some push from the large, but temporary, spurt in some other wage and salary rates at the end of the freeze. During January about $1¾ billion of the $6 billion expansion in wage and salary disbursements reflected the pay raise for Federal employees provided for in the amended Economic Stabilization Act.

The reductions in Federal personal income taxes that took effect at the beginning of the year should also help to stimulate consumer spending in coming months. On the other hand, the new withholding schedules that also went into effect at the beginning of the year run counter to this stimulus by increasing the amounts of taxes withheld. The dampening effect of the new schedules on consumer spending may be mitigated as more and more taxpayers increase their take-home pay, however, by taking advantage of a new provision which permits the claiming of withholding allowances in addition to the exemptions allowed in computing tax liabilities.

Larger wage and salary payments in January were partly offset by a $1.6 billion increase in social security contributions. These act as a drag on personal incomes because only net social security payments—benefit payments minus personal contributions—are counted in personal income. This increase in contributions was largely the result of a rise in the taxable wage and salary base for social security from $7,800 to $9,000. Although most of those affected will not feel the impact of this change until later in the year when their incomes surpass the old tax base, the Department of Commerce imputes the tax to income throughout the year.

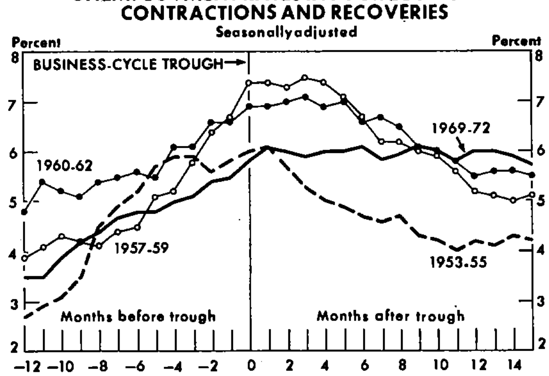
LABOR MARKET DEVELOPMENTS

One of the most distinctive features of the 1971 recovery from the 1969-70 recession was the failure of the unemployment rate to break out of a narrow band around 6 percent. During the comparable stages of the recoveries from previous post-Korean war recessions, in contrast, the unemployment rate had declined substantially (see Chart II). Since the end of 1971, however, the unemployment rate has slipped from 6.0 percent in December to 5.9 percent in January and 5.7 percent in February, its lowest point in more than a year. It should be noted that these declines are of borderline significance in a statistical sense.

Chart II

UNEMPLOYMENT RATES 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 Labor Statistics.

In other words, they could well have been the result of chance or random movements in the underlying data. Moreover, the February drop in the unemployment rate resulted from a small contraction of about 170,000 persons in the seasonally adjusted civilian labor force with employment unchanged, according to the Bureau of Labor Statistics survey of households. Nevertheless, it appears that some improvement in labor market conditions has taken place since mid-1971.

During the recent recession—which the National Bureau of Economic Research has tentatively dated as extending from November 1969 through November 1970—there was very little change in civilian employment as measured by the monthly survey of households. However, since the civilian labor force continued to grow, the unemployment rate climbed from 3.5 percent in November 1969 to 5.8 percent a year later. Employment remained essentially stable for several months thereafter, while the growth in the civilian labor force flattened out. About midway through 1971, employment began to climb swiftly, but the rise was about met by accelerated growth in the labor force. Indeed, in the four-month period from July through November 1971, the civilian labor force grew by about 1.2 million persons, after having risen by less than ½ million individuals in the preceding seven months. Since late last year, the growth in the civilian labor force appears to have leveled off temporarily.

Some corroboration of the improvement in labor market conditions since midsummer 1971 is provided by the monthly survey of establishments, which is conducted independently of the household survey. A small increase in seasonally adjusted payroll employment during February plus a sizable upward revision of the January total brought the rise in payroll employment over the seven months ended in February of this year to 1.2 million, in contrast to the 0.2 million job increase during the first seven months of last year. However, not all sectors of the economy have shared in this advance in employment. In manufacturing, for example, employment in February was virtually the same as a year earlier.

RECENT PRICE DEVELOPMENTS

While the interpretation of month-to-month price changes has always required careful analysis, this task has been further complicated by the special effects associated with the New Economic Policy inflation controls. After the dramatic slowing that marked the ninety-day freeze, consumer and wholesale prices rose briskly during December and January, the first full months of Phase Two. However, at least some acceleration was to be expected during this transitional period in the aftermath of the freeze. Many price increases that would have taken effect between August and November were held up by the freeze. When combined or "bunched" with the other increases that have taken place since November, they have helped produce a quickening in the pace of price changes. Thus, while it is still far too early to judge the successes of Phase Two controls in dealing with inflation, it is worth noting that—even including these recent transitional effects—inflation rates for the entire period since the start of the New Economic Policy have been considerably smaller than those experienced for several years.

In January, seasonally adjusted consumer prices rose at a 3.2 percent annual rate as compared with the 4.6 percent rise registered in December. Food prices, which are the most volatile of the consumer price categories even after allowance for seasonal movements, declined at a 2 percent annual rate in January, after climbing at an 8 percent rate during each of the preceding two months. Prices of services jumped ahead at a sharp 6.4 percent annual rate (not seasonally adjusted) in January, largely as a consequence of higher property taxes and car registration fees both of which are exempt from current Federal controls. Increases in prices of nonfood commodities slowed to a 2 percent annual rate in January after December's 4.1 percent surge. Since August, nonfood commodities prices have risen at a 1.2 percent annual pace, appreciably slower than the approximately 3 percent rise posted in the first eight months of last year.

Prices of industrial wholesale commodities rose at a 4.7 percent seasonally adjusted annual rate in January, following December's 3.1 percent advance and the slight decline registered over the months of the freeze. Nonetheless, wholesale industrial prices have increased at less than a 1 percent annual rate from August to January in contrast to the pace of almost 5 percent over the first eight months of 1971. Movements in the overall wholesale price index continue to reflect the large and rather erratic behavior of agricultural prices which have, on a monthly basis, gyrated at annual rates ranging between minus 20 and plus 30 percent over the year ended in January.