The Business Situation

Recent data continue to point to a strengthening of the economic recovery. During February, industrial production exhibited a strong and broadly based advance and private housing units were started at a record rate. Consumers shed some of their lethargy and stepped up their purchases in February and March. Civilian employment rose strongly in March. An even larger increase in the civilian labor force, however, resulted in a slight rise in the unemployment rate. Orders placed for durable manufactured goods in February were well above the December level, even though a sharp decline in the volatile defense category resulted in a retreat of total bookings from the record high reached in January. Notwithstanding these indications of a quickening in the pace of the recovery, businessmen have continued to approach their inventory building with caution.

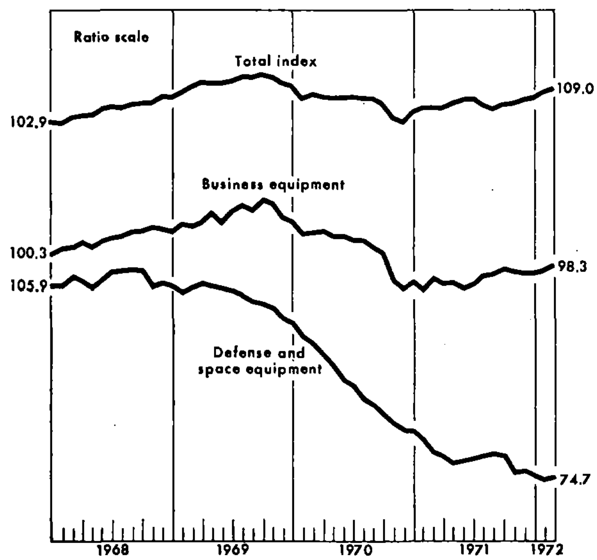
Developments in prices and wages suggest that inflation remains a serious problem. Large increases in food prices gave a sharp boost to both the consumer and wholesale price indexes in February. While wholesale agricultural prices declined slightly in March, prices of industrial commodities continued to rise at a disturbingly rapid rate. From November 1971 through March 1972, average hourly earnings of production and nonsupervisory workers in the private nonfarm economy rose at a rapid 8½ percent annual rate. To be sure, part of this rise reflected a clustering of wage increases in the aftermath of the freeze. Nevertheless, while data for February and March combined show some deceleration of wage increases, it is too early to conclude that a well-defined moderation of wage pressures is under way.

PRODUCTION, ORDERS, AND INVENTORIES

During February, the physical output of the nation's factories, mines, and utilities—as measured by the Federal Reserve Board's index of industrial production—rose at a fast 8.9 percent seasonally adjusted annual rate from January's upward revised level (see Chart I). Apart from several months which were affected by special temporary distortions, the February advance was the largest since the recovery started toward the close of 1970. Perhaps even more important is the fact that the February strengthening of output was broadly based. A sizable February increase, together with an upward revision for January, may indicate that production of business equipment is breaking out of the flat pattern that prevailed over the last half of 1971. This would be broadly consistent with the findings of recent Government and private surveys of capital spending planned for this year. There were, moreover, signs of some further leveling-off in the protracted decline of defense and aerospace output which had fallen more than 30 percent since mid-1968.

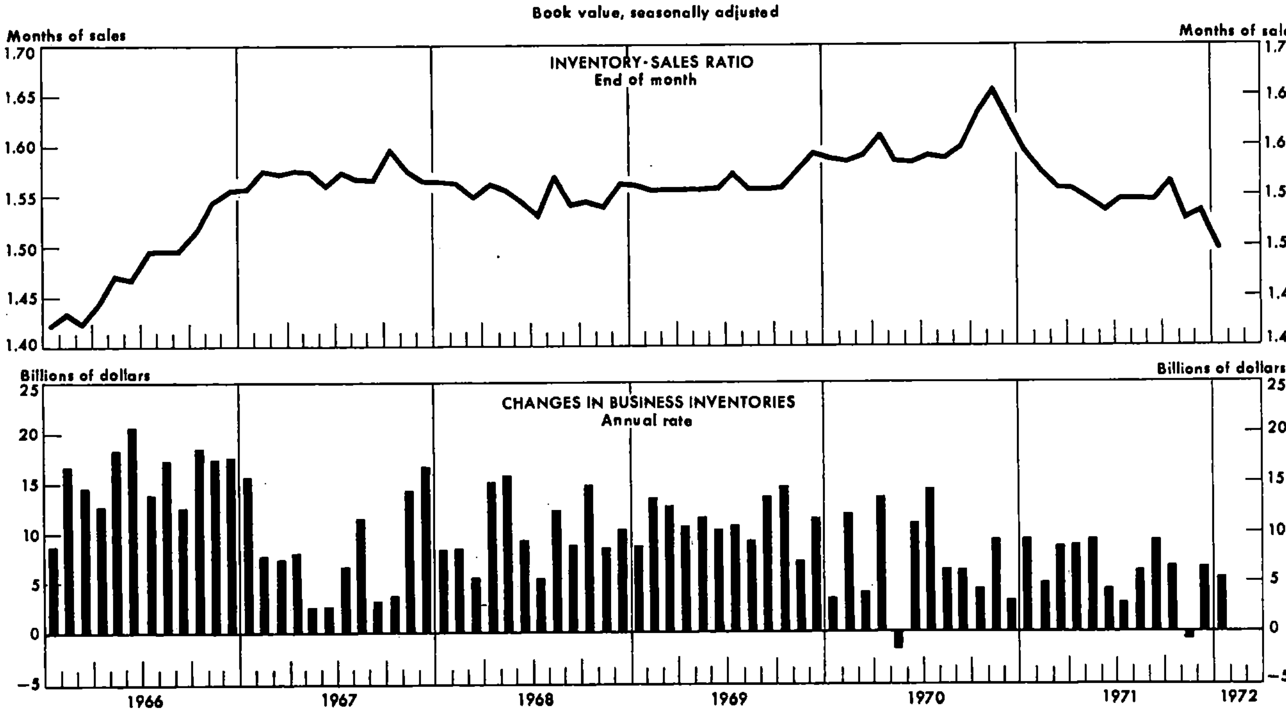
Total industrial production rose at an annual rate of 7 percent from August 1971 through February, in contrast to the 1 percent pace that characterized the first eight

Chart I
INDUSTRIAL PRODUCTION
Seasonally adjusted; 1967=100



Source: Board of Governors of the Federal Reserve System.

Chart II
BUSINESS INVENTORIES
Book value, seasonally adjusted



Source: United States Department of Commerce, Bureau of the Census.

months of last year. If those industries where actual and threatened labor disputes have had a major impact on the production index are excluded, the gain since August is reduced to about 5 percent but still reveals a quickening relative to earlier last year. Despite the strengthening of recent months, total production in February was still 2.6 percent below the September 1969 high and had climbed only 3 percent above its year-earlier level.

Orders placed with manufacturers of durable goods during February were a healthy 7.2 percent above their December level, even though a sharp decline in the very volatile defense category caused bookings to recede from their record January inflow. Excluding defense, the new orders inflow reached record proportions during February. After following a comparatively flat pattern over much of 1971, durable goods new orders have advanced rapidly since October of last year, registering a total gain of about 10.6 percent. For nondefense orders, the advance amounted to an even sharper 12.0 percent. Orders placed with iron and steel producers strengthened further in February to 45 percent above the low reached this past August immediately after the steel labor contract settlement. All of the sizable February decline in bookings for producers' capital goods industries appeared to result from the drop in defense orders. Despite the rise in durables shipments during February, the unfilled orders backlog rose for the fourth straight month to a level 3.7 percent above the five-year low reached last October.

Over much of the recovery period, the expiration and renewal of key collective bargaining agreements have been important determinants of movements in business inventories. For example, automotive inventories were in the process of being rebuilt during early 1971, after the conclusion of the General Motors strike. In anticipation of a midsummer steel strike, a sizable stockpile of materials was accumulated and has since been gradually diminished. Longshore labor disputes starting last summer have also had an impact on the inventory picture. Thoughout all this, businessmen have approached their inventory spending with caution, allowing their inventories to rise at a slower rate than sales. As a consequence, the inventory-sales ratio has fallen appreciably over the last year or so. During January, the increase in the book value of business inventories was a modest $5.4 billion annual rate (see Chart II), which is a bit smaller than the $6.3 billion average rise over the previous twelve months. Coupled with a substantial rise in sales, which was especially notable in manufacturing and wholesale trade, the inventory-sales ratio fell to 1.50 in January, its lowest level since mid-1966. With inventories currently so lean relative to sales, the likelihood is enhanced that the pace of inventory accumulation will accelerate in response to rising business sales.

Preliminary February manufacturing data, however, indicate an inventory decline of $1 billion at a seasonally adjusted annual rate, coming on the heels of the previous month's large $4 billion increase. Over the first two months of 1972 the book value of manufacturers' holdings rose at a $1.5 billion annual rate. Although this is considerably slower than the $4 billion increase planned for the first quarter as a whole according to a recent Government survey of manufacturers' inventory spending intentions, a first-quarter rise in the $1.5 billion range would represent some improvement over the previous year when manufacturers' inventories were virtually unchanged. The February rise in manufacturers' shipments was modest, especially by comparison with the January surge. Excluding the normally volatile transportation sector, shipments declined but were still 2.4 percent above December and 8.8 percent higher than twelve months earlier. Shipments of blast furnace and steel mill products strengthened further in February and were a full 60 percent above their depressed August level. For all manufacturers, the ratio of inventories to sales slipped to 1.63, its lowest mark since the first half of 1966.

RESIDENTIAL CONSTRUCTION

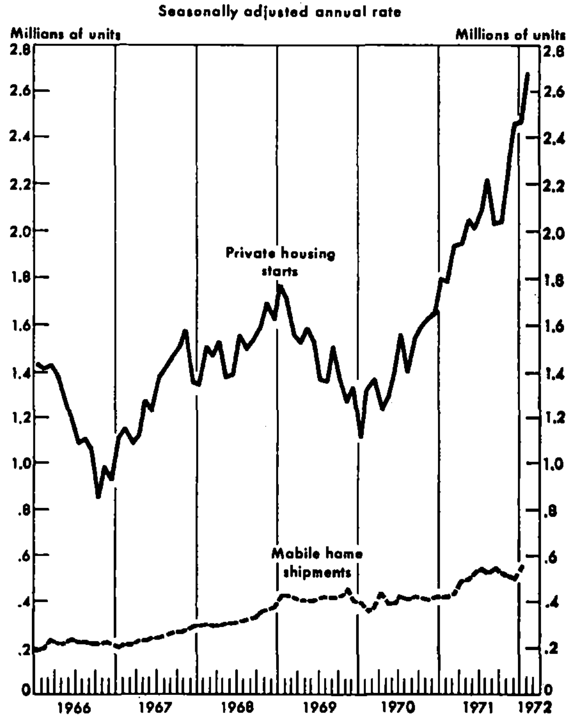
The housing boom has continued to show exceptional vigor. During February, the total number of private housing units started soared to a record 2.7 million unit seasonally adjusted annual rate, according to preliminary data (see Chart III). By comparison, housing starts had fallen to a low of 1.1 million units in January 1970. At the same time, the number of newly issued building permits in February edged past January's high level but were 8 percent below the record set last December. All of the rise in February starts was in multi-unit dwellings, while the number of single-family residences started during the month actually declined. Moreover, the regional pattern during February was quite mixed, with starts off 35 percent in the northeast states while jumping 33 percent from January in the north central area.

The protracted residential construction boom has been dependent on a number of interlocking factors. After virtually evaporating in late 1969 and early 1970, deposit inflows to thrift institutions—which are the primary providers of home mortgage credit—increased substantially later in 1970 and rose to record proportions in 1971 and again in early 1972. These inflows have been generated and sustained in large part by the relative attractiveness of yields on savings accounts, compared with alternative market instruments, and also by the high rate of personal savings. Not only has this deposit growth supported a very heavy volume of mortgage lending, it has also helped induce some easing in the terms of mortgage credit. For example, by February the average effective interest rate on conventional first mortgages for new homes granted by savings and loan associations had moved below its level at the end of 1971 and was about 1 percentage point beneath the peak reached in 1970. There has also taken place a

Chart III

PRIVATE HOUSING STARTS AND MOBILE HOME SHIPMENTS

Seasonally adjusted annual rate



Sources: United States Department of Commerce, Bureau of the Census; Mobile Home Manufacturers Association.

reduction of downpayment requirements and a lengthening of the average loan maturity. Interest rates and other characteristics of conventional first-mortgage loans made by all types of lenders have moved in roughly similar fashion.

Shipments of mobile homes, which represent an increasingly important component of the total supply of living units, rose to a record seasonally adjusted annual rate of 554,000 units during January, the latest month for which data are available. Mobile home shipments have risen rapidly from 191,000 in 1964 to 487,000 last year. The factors behind this surge are numerous. Regulations governing the availability of credit for purchase of mobile homes have been eased in recent years; in addition, those groups most likely to purchase such homes—families with heads under age thirty-five and over age fifty-five—have become an increasing proportion of the population. Greater size and diversity of mobile homes, together with lower costs relative to conventional single-family housing, have also boosted sales.

CONSUMPTION, INCOME, AND EMPLOYMENT

According to very preliminary data, it appears that seasonally adjusted retail sales picked up considerably in March, reaching a record $36 billion. This represented an increase of $0.9 billion over the upward revised February pace. Sales of both durable and nondurable goods posted large gains in March. Thus, while the March data are subject to revisions, these latest readings on retail activity suggest that sales seem to be breaking out of the sluggish pattern that prevailed at the turn of the year. Yet, even with this substantial increase, March retail sales totaled only $0.4 billion above the previous record set in November 1971.

Personal income rose by $4.9 billion during February, following increases averaging a substantial $8.6 billion during the two previous months. After adjustment for identifiable special factors such as the Federal military and civilian pay raises in December and January, however, the February increase in personal income was only slightly smaller than the gains in those months. Increased wage and salary disbursements accounted for $3.7 billion of the February advance, with government payrolls up $0.6 billion or about one-fourth as large as the previous month's gain which was swollen by the Federal pay raise. The sizable gain of $1.7 billion in manufacturing wage and salary disbursements in February appears largely the result of the rebound in the factory workweek and hours of overtime.

Employment rose sharply in March, continuing the strength exhibited over the previous six months. According to the Bureau of Labor Statistics survey of employers, 276,000 workers were added to nonfarm payrolls in March on a seasonally adjusted basis, an impressive 4.6 percent annual rate of increase. The gains were broadly based, moreover, including a notable pickup in manufacturing employment. Since August 1971, nonfarm payroll employment has increased at a 3.5 percent seasonally adjusted annual rate, compared with only 1 percent during the nine months from November 1970—the month tentatively identified by the National Bureau of Economic Research as marking the trough of the 1969-70 recession—through August 1971. Since then, employment in manufacturing has risen at a 2.9 percent seasonally adjusted annual rate, in contrast to an outright decline during the previous nine months. Even larger percentage gains since August have occurred in employment in the government, transportation and public utilities, finance, services, and trade areas.

In March the substantial gains in civilian employment were accompanied by large increases in the civilian labor force. Consequently, the unemployment rate edged up from 5.7 percent in February to 5.9 percent in March. This was equal to the January rate and only a shade below the average unemployment rate of 6 percent during 1971. The rate of unemployment among married men remained at 2.8 percent in March, however, the same as in February and otherwise the lowest since mid-1970. The increase in joblessness during March was centered in adult women, whose unemployment rate nevertheless remained below that for January 1972 and for 1971 as a whole.

WAGES AND PRICES

Over the four months from November 1971 through March 1972, average hourly earnings of production and nonsupervisory workers in the private nonfarm economy increased at a rapid 8.6 percent seasonally adjusted annual rate. This rise compares with a rate of only 2.3 percent during the three previous months—which approximate the period of the wage freeze—and 6.8 percent over the first eight months of 1971. The rate of increase in earnings has varied considerably during the past four months, spurting to a seasonally adjusted annual rate of 14 percent in December, slowing to 7 percent and 3½ percent in January and February, respectively, and accelerating to 10 percent in March. Part of these month-to-month fluctuations, however, is attributable to changes in overtime hours and shifts in the composition of employment between industries with different wage levels. To remove distortions arising from these factors, the Bureau of Labor Statistics has recently presented an index of average hourly earnings of production and nonsupervisory workers that is adjusted for overtime in manufacturing and also holds constant the distribution of workers in all private nonfarm industries. By comparison with the traditional earnings series, the new series shows even sharper rises in wage rates in December and January but somewhat more moderation thereafter. Thus, over the two months, February and March, the adjusted series indicates a 4.5 percent seasonally adjusted annual rate of increase in earnings, compared with 6.8 percent according to the series that is not adjusted for changes in overtime and interindustry shifts of employment. These signs of apparent moderation in wage pressures, however, are based on too short a time period to be considered conclusive.

On a quarterly average basis, average hourly earnings of production and nonsupervisory workers in the private nonfarm economy rose 7.3 percent at a seasonally adjusted annual rate in the first three months of 1972 from the level of the previous quarter. In part, this increase was attributable to the surge in December which reflected a bunching of increases in the wake of the freeze. While that rise did not occur in the first quarter, it nevertheless had the effect of raising the average level of wages in the first quarter above the fourth-quarter average. The first quarter's increase in earnings represented the fastest rate of growth since the first quarter of 1971, when earnings also increased at a 7.3 percent annual rate. In that quarter, however, compensation per man-hour—the most comprehensive measure of wages and salaries—rose at an 8.9 percent annual rate. It would seem likely that the rate of increase in compensation per man-hour, which will be available later this month, exceeded that of average hourly earnings in the first quarter of 1972 as well. This is because certain components of employee compensation such as employer contributions for social security, certain other fringe benefits, and retroactive payments made to workers for pay increases held up by the freeze are not included in the earnings data but will contribute to the rise in compensation per man-hour. However, part of the upward thrust to compensation in the first quarter—such as the clustering of wage increases following the freeze, retroactive wage increases, and the higher level of employer contributions necessitated by the January rise in the social security tax base—is nonrecurring. Therefore, the first-quarter readings on compensation per man-hour will be of limited usefulness in evaluating the effectiveness of the Phase Two wage controls.

Overall wholesale prices rose at an annual rate of 1.3 percent in March, down from the rapid 8.8 percent rate of increase in February. The slowdown primarily reflected a decline in the prices of farm products and processed foods and feeds at a seasonally adjusted annual rate of 3 percent in March following a 21.5 percent rate of advance in February. In spite of the slight decline in March, such prices—many of which are exempt from controls—have soared at a seasonally adjusted annual rate of 11.4 percent over the six months that ended in March.

In the industrial sector, wholesale prices rose at a 4 percent seasonally adjusted annual rate in March, which was only slightly less than the 4.6 percent rate of increase in February. After declining at a 1.3 percent annual rate during the months from August through November, which roughly corresponded to the period of the price freeze, industrial wholesale prices have risen at a 4.1 percent annual rate during the succeeding four months. To be sure, while these increases continue to reflect some catch-up activity from the freeze, they do nonetheless represent a modest improvement over the experience of the first eight months of 1971, when such prices rose at a 4.9 percent annual rate. Nevertheless, the continued rapid increase in industrial prices four months after the end of the freeze is discouraging.

Largely as a result of a surge in food prices, particularly meat, the consumer price index jumped at a sharp 6.4 percent seasonally adjusted annual rate during February. Prices of food consumed at home, accounting for about 17 percent of the overall index, rose at a 24 percent seasonally adjusted annual rate in February. Yet there is a likelihood that more ample supplies of meat, and hence considerably lessened pressure on food prices, will be forthcoming later this year. Indeed, prices received by farmers declined in March, and this decline may eventually be transmitted to prices at the consumer level. Moreover, the recent bulge in food prices has tended to obscure some important improvements in the behavior of other major consumer price components. The increase in prices of services, which make up about 37 percent of the total consumer price index, slowed to a 2.7 percent annual rate in February after a substantial 6 percent jump at an annual rate in January. Since the wage-price freeze, price increases for services, which are available only on a nonseasonally adjusted basis, slowed slightly to a 4.3 percent annual rate from the 4.5 percent pace posted for the first eight months of 1971. Furthermore, prices of nonfood commodities, which constitute approximately 40 percent of the total index, actually declined on a seasonally adjusted basis during February, following a moderate rise of 2 percent in January.