The Business Situation

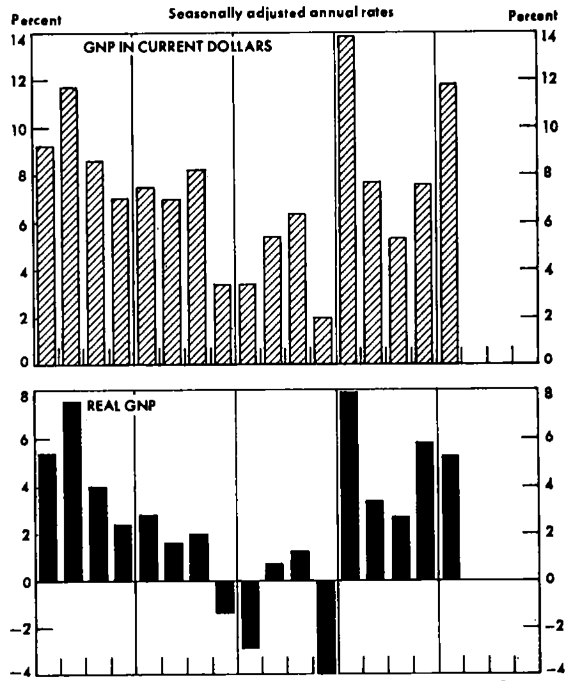
The most recent business statistics provide further evidence of a broadly based quickening in the pace of economic activity. Industrial production posted a pervasive and strong increase in March, and payroll employment continued to show upward momentum in April. Real gross national product (GNP) advanced at a healthy 5.3 percent annual rate in the first quarter as almost all sectors shared in the advance. Retail sales rose sharply in March, and scattered indications of an improvement in consumer attitudes suggest that some further gains may occur in this area during the months ahead. In spite of these signs of strengthening economic activity, business spending for inventories has remained cautious and unemployment has remained at recent high levels.

The latest readings on prices and wages have been somewhat mixed and do not yet provide a clear indication of the overall effectiveness of Phase Two policies. Certainly the most favorable price development in the Phase Two period thus far was the virtual stability displayed by consumer prices in March. On the other hand, the implicit GNP price deflator and compensation per hour of work in the private economy—the broadest measures of prices and wages, respectively—posted large increases in the first quarter. These rapid gains were in part a reflection of the bunching of wage and price increases in the aftermath of the freeze. Thus, neither of these advances is necessarily representative of the underlying inflationary situation within the quarter. In April, industrial wholesale prices continued to rise at the same disappointingly rapid pace of the previous four months.

GROSS NATIONAL PRODUCT AND RELATED DEVELOPMENTS

According to preliminary estimates by the Department of Commerce, the market value of the nation's output of goods and services rose by $30.3 billion during the first quarter to a seasonally adjusted annual rate of $1,103.2 billion. About half of this growth was accounted for by price increases, as the GNP implicit price deflator advanced rapidly in the aftermath of the price freeze. After adjustment for changes in the price level, the first-quarter increase in real GNP was at a 5.3 percent annual rate. This gain, coming on the heels of the sizable advance in real GNP in the fourth quarter of 1971, brought growth in the six months ended in March to an annual rate of 5.6 percent. With the exception of the first half of 1971,

Chart I
CHANGES IN NOMINAL AND REAL GROSS NATIONAL PRODUCT
Seasonally adjusted annual rates



Source: United States Department of Commerce.

when activity was artificially boosted by the recovery from the automotive strike, this was the largest gain in real GNP over any two consecutive quarters since the middle of 1968 (see Chart I).

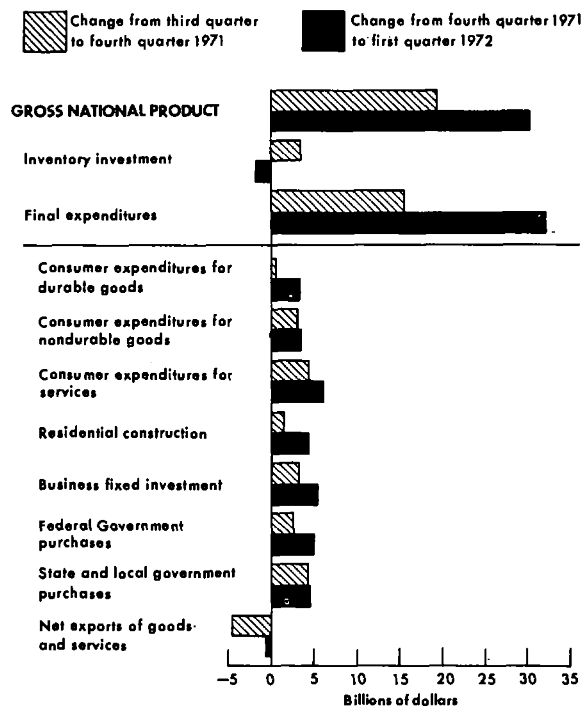
The rapid growth in GNP in the first quarter was accomplished despite persistent sluggishness in inventory spending. Based on incomplete data, inventory accumulation in GNP terms amounted to only $0.6 billion (annual rate) in the January-March period, compared with the already low $2.4 billion rate in the preceding quarter, thus causing a $1.8 billion drag on the overall advance of GNP. While available data do not provide evidence that the long-anticipated expansion in inventory investment has begun, the potential for an acceleration in inventory spending in the months ahead was enhanced by some developments in the first quarter. For example, the substantial gain in new orders for durable goods is expected to add to inventories of goods in process during the coming months as production of these goods progresses. Moreover, with inventory-sales ratios low in virtually every sector, further strengthening in capital spending should increase the demand for inventories.

The first-quarter rise in current-dollar final expenditures —i.e., GNP net of inventory accumulation—amounted to a strong $32.2 billion, or 12.6 percent at an annual rate. In real terms, final spending rose at a rapid 6.5 percent annual rate, considerably above the pace of the three preceding quarters. The overall gain in final spending was paced by a significant expansion in business fixed investment spending and by large increases in outlays for new residential construction (see Chart II).

Chart II

RECENT CHANGES IN GROSS NATIONAL PRODUCT AND ITS COMPONENTS

Seasonally adjusted



Source: United States Department of Commerce.

Business fixed investment grew by $5.5 billion in the January-March period. The gain was concentrated almost exclusively in expenditures for producers' durable equipment, including trucks and aircraft. This exceptional advance in capital spending provides evidence of the stronger pace of investment outlays which had been anticipated for 1972. For example, the February survey of capital spending plans conducted by the Department of Commerce revealed that such investment was expected to rise by approximately 10½ percent in 1972, and a more recent McGraw-Hill survey indicated an even stronger advance of about 14 percent. In comparison, plant and equipment expenditures rose by a small 1.9 percent in 1971. The improved outlook for business fixed investment spending is also seen in the recent strengthening in production of business equipment and in new orders for capital goods.

Spending on residential construction expanded sharply in the first quarter, rising by $4.6 billion to a record level, as the upward momentum in the home-building boom continued. Moreover, despite the duration and intensity of the current upswing in the housing sector, there are indications that further—though smaller—gains in spending may yet materialize. For example, although housing starts eased somewhat in March from the record levels attained earlier in the quarter, over the January-March period as a whole starts averaged an unprecedented 2.5 million units at an annual rate. Furthermore, current and near-term conditions in the mortgage markets remain favorable insofar as the availability of mortgage credit is concerned. This is suggested by the strong first-quarter flow of deposits to thrift institutions and the sharp rise in their mortgage commitments.

Personal consumption expenditures rose $13 billion in the first quarter to a seasonally adjusted annual rate of $690.2 billion. The rise in consumer spending was broadly based as outlays on durables, nondurables, and services all posted relatively good gains. The rise in durables was paced by a substantial gain in purchases of furniture and household equipment which was at least partially related to the housing boom. The first-quarter rise in consumption spending, as measured in the GNP accounts, reflected the marked upsurge in retail sales activity that occurred toward the end of the quarter. Retail sales expanded in February and then posted a huge increase in March. Scattered indications of improved consumer confidence, moreover, enhance the possibility of further substantial expansion in consumer spending.

The underlying behavior of personal income, disposable income, and the savings rate in the first quarter was obscured by a number of special factors. Personal income rose by a substantial $23.2 billion, a seasonally adjusted annual rate of gain of 11.0 percent. In part, this advance reflected the strong showing of employment as well as Federal civilian and military pay increases. Beyond this, the clustering of pay increases in the aftermath of the freeze, as well as the incorporation into the data of retroactive pay raises granted by the Pay Board, also contributed to the first-quarter rise in personal income. While an exact calculation is not possible, it is estimated that these nonrecurring factors added $8 billion to $9 billion to personal income in the first quarter. However, despite the large increase in personal income, disposable (after-tax) income rose by only $10.7 billion. The large difference was the result of the substantial overwithholding of Federal personal income taxes which occurred in the quarter as a consequence of changes in withholding schedules that took effect in January. It has been estimated that overwithholding increased Federal tax payments by $8 billion (annual rate) and thereby reduced disposable income by a similar amount. Thus, insofar as disposable income is concerned, the overwithholding situation largely counterbalanced the impact of the nonrecurring gains in personal income noted above. Against this background, the first-quarter decline in the savings rate to 7.4 percent may be indicative of a greater willingness to spend on the part of consumers.

Government purchases of goods and services contributed $9.6 billion to the first-quarter GNP advance. Federal spending increased by $5.0 billion, a little more than half of which reflected Federal civilian and military pay increases. Even apart from the pay increases, however, defense spending quickened in the first quarter. In combination, this brought Federal sector spending for defense back to its highest level since the first quarter of 1970. However, the recovery in defense spending still appears to be of modest proportions, as the industrial production index for defense goods has merely leveled out in recent months at a reading about 31 percent below the August 1968 peak. At the state and local level, spending rose $4.6 billion, a bit larger than the increase of the previous quarter.

PRICES, WAGES, PRODUCTIVITY, AND EMPLOYMENT

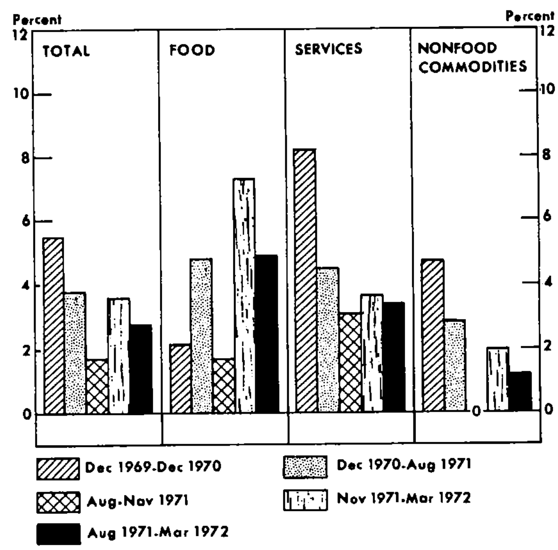
In Phase Two thus far, most of the broader price indexes have risen at about the same rates that had prevailed over the eight-month period prior to the price freeze. To a considerable extent, however, these data overstate underlying inflationary forces, since increases that might otherwise have occurred in earlier months tended to be bunched in the post-freeze period.

Certainly the most favorable price development in the Phase Two period has been the stability displayed by consumer prices in March, when the index, seasonally adjusted, was virtually unchanged from its February level. Over the first four months of Phase Two, consumer prices moved up at a seasonally adjusted annual rate of 3.6 percent, barely below the pace of the first eight months of 1971 but sharply below the advance during 1970 (see Chart III). Much of the recent rise reflected the surge in retail food prices, which climbed at a 7.3 percent annual rate from November through March. Food prices are in part exempt from controls and respond rather quickly to changes in agricultural supply conditions. Nonfood commodity prices, on the other hand, advanced at a more modest 2.0 percent rate during the first four months of

Chart III

RECENT CHANGES IN CONSUMER PRICES

Annual rates



Note: Data are seasonally adjusted with the exception of services.

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

Phase Two, thus continuing the improvement already evident in this category before the price freeze.

At the wholesale level, the rise in prices over the five-month period ended in April was at about the same rate as during the first eight months of 1971. This is, to a considerable extent, a manifestation of the catch-up bulge that had been expected as well as the net advance in agricultural prices. In the industrial sector, wholesale price increases slowed only modestly during Phase Two relative to their pre-freeze pace, a disappointing result. At the same time, the farm products and processed foods and feeds component rose sharply. However, over the eight months since August, covering the freeze and Phase Two, there has been perceptible improvement in the performance of industrial wholesale prices and of the index in general. A potentially favorable development was the mid-April announcement by major steel producers imposing a virtual freeze on prices of most steel mill products. Industrial wholesale prices could benefit directly from this action, and there may be spillover benefits as well since steel is an important intermediate product.

The most comprehensive available measure of price behavior, the implicit GNP price deflator, increased at a 6.2 percent annual rate in the first quarter, according to preliminary estimates. Even after making allowance for a probable downward revision in the deflator in light of the March consumer price data (which were not available when the GNP estimates were prepared), the first-quarter rise represented a pronounced acceleration from the 1.7 percent rate of increase in the previous quarter. However, because of nonrecurring factors, including the post-freeze clustering of price increases and the Federal pay raises, the first-quarter showing of the deflator does not provide an accurate representation of the underlying inflationary situation during this period. For example, the Federal pay raises contributed approximately 1 percentage point to the first-quarter jump in the deflator. Beyond this, shifts in the composition of output in the first quarter toward relatively high-priced goods, such as residential structures, also contributed to the acceleration in the deflator because this index is a weighted average of component price indexes, with the weights determined by the composition of output in each quarter. Thus, the chain price index for the private economy—which eliminates price changes stemming from Government pay raises and changes in the composition of output—rose at a 4.6 percent annual rate in the first quarter. Even this index does not eliminate the bulge arising from the post-freeze clustering of price changes. Nevertheless, it is noteworthy that the rise in the private deflator for the four quarters ended in the first quarter of 1972 was 3.3 percent, a distinct slowing relative to the performance of the last several years. For example, the increase over the four quarters ended in the first quarter of 1971 amounted to nearly 5 percent.

Recent data on wages and salaries also have been affected by a post-freeze clustering of increases. As expected, compensation per hour of work in the private economy rose rapidly in the first quarter, posting an 8.6 percent annual rate of increase. This advance was spurred both by the post-freeze clustering in pay raises and by increased employer contributions to social security. Average hourly earnings—one of the monthly sources for the series on compensation per hour of work—posted sharp gains in December and January, in part stemming from the concentration of increases after the termination of the freeze. All these factors contributed to the first-quarter rise in compensation per hour of work and, while there was a deceleration in the advance of average hourly earnings on balance over the February-April interval, gains remained large nevertheless.

Productivity, as measured by the index of real output per hour of work, increased at a 3.7 percent annual rate in the private nonfarm economy in the first quarter. While this rise was somewhat slower than that posted in the preceding quarter, it was considerably more rapid than the corresponding productivity gain registered over the six-month period ended in September 1971. In contrast to the first-quarter advance in productivity in the private nonfarm economy, there was a decline in output per hour of work in the farm sector which resulted primarily from a decrease in real output. As a consequence, productivity in the private economy as a whole rose at a relatively sluggish 2.1 percent annual rate in the January-March interval. With the substantial gain in compensation per hour of work and small growth in productivity in the private economy, labor costs per unit of output climbed at a 6.3 percent annual rate, the fastest quarterly rise in unit labor costs in two years. However, over the six months ended in March, including much of the freeze and Phase Two, the advance in unit labor costs was at a 3.6 percent rate, a somewhat less disturbing picture of cost pressures. Moreover, it is still too early at this stage to evaluate the overall effectiveness of the wage controls because of the special factors which have influenced recent data.

The latest Bureau of Labor Statistics survey reveals some moderation in the rate of increase in wages and benefits under major collective bargaining agreements during the first quarter relative to the performance of recent years. Perhaps the most promising development occurred in the manufacturing sector, where settlements approved during the first three months of this year provided for mean life-of-contract wage and benefit increases of 6.1

percent, down significantly from 7.7 percent for 1971 as a whole. Similarly, the average life-of-contract settlement for all industries slowed in the first quarter, although overall improvement was tempered by the large gains granted to railroad workers. The rail contract, which was negotiated prior to the freeze but not approved by the Pay Board until January, weighed heavily in the first-quarter collective bargaining results because it covered more than one third of the total number of workers included in the settlement data. It might also be noted that there apparently were a fairly sizable number of wage contracts involving fewer than 1,000 workers that took effect in the quarter and provided for wage increases well below those experienced in the major contract settlement data referred to above.

The underlying trend in employment continues to exhibit strength. According to the Bureau of Labor Statistics survey of employers, seasonally adjusted nonfarm payrolls rose by 182,000 workers in April, after increasing by more than 800,000 workers during the first quarter. Over the six-month period ended in April, nonfarm payroll employment rose at an annual rate of 3.7 percent. Notably, employment in manufacturing industries climbed substantially over the first four months of 1972, after stagnating during most of 1971. These gains brought manufacturing employment in April to the highest level since September 1970. At the same time, the average factory workweek and hours of overtime have risen above the levels prevailing throughout 1971. Nevertheless, the monthly household survey indicated that the unemployment rate remained at a seasonally adjusted 5.9 percent in April, little changed from the average for 1971 as a whole.