The Business Situation

Recent data confirm that an impressive expansion in economic activity is under way. In April, industrial production registered its strongest overall advance in sixteen months, with particularly sharp increases in the consumer durables and business equipment categories. Personal income posted a healthy advance during the month, and retail sales rose sizably on balance over the March-April period. Further, sales of domestic automobiles in May were at the fastest pace since last October, when sales were boosted by the price freeze. Labor market conditions have also continued to improve, as evidenced by the sizable increase in payroll employment in May, almost half of which was in manufacturing. On the other hand, the unemployment rate has continued high, inventory spending has remained quite modest, and the rate of residential housing starts, which had been exceptionally strong, has slackened a bit.

Price and wage data still provide no firm basis on which to judge the success of the Phase Two programs to combat inflation. Consumer prices rose at a modest seasonally adjusted annual rate of 2 percent in April after showing little change in the previous month. Thus far in Phase Two, consumer prices have increased at a 3.3 percent annual rate, somewhat below the pace of the first eight months of 1971 and considerably below that of 1970 and 1969. However, industrial wholesale prices continued to climb rapidly in May, and wholesale prices of farm products and processed foods and feeds rose sharply. There is some evidence that wage gains have moderated recently, following the post-freeze bunching of increases.

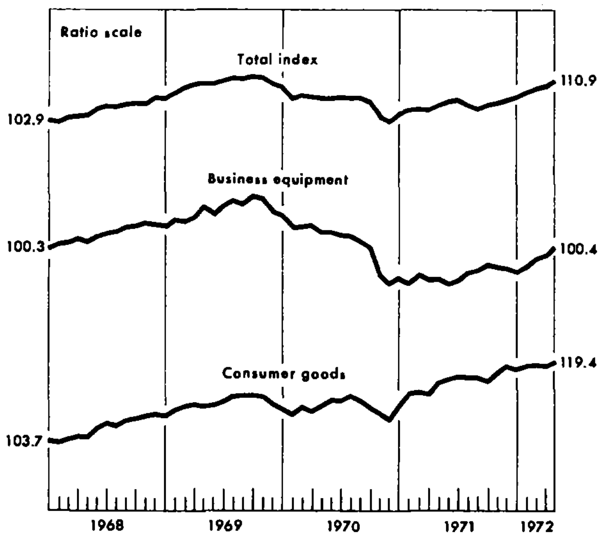
PRODUCTION, ORDERS, AND INVENTORIES

The Federal Reserve Board's index of industrial production rose by a large 1 percent in April, when especially sharp gains in the production of business equipment, materials, and consumer durables occurred. Over the first four months of 1972, industrial production advanced at a rapid 9 percent seasonally adjusted annual rate, in contrast to an increase of only 3 percent over 1971 as a whole. By April, the index was 4.4 percent above the level of a year earlier and about 8 percent above the recession low of November 1970, but nevertheless was still almost 1 percent below its peak attained in the fall of 1969.

Sharply higher levels of business equipment output have been one of the major elements contributing to the overall rise in industrial production so far this year (see Chart I). The April gain of 1.3 percent brought the advance in the production of business equipment since December 1971 to a seasonally adjusted annual rate of nearly 12 percent, well above the sluggish performance of 1971. Materials production also climbed 1.3 percent, in part reflecting an increase in steel ingot production. The production of consumer goods rose 0.9 percent in April, with gains in the output of furniture, carpeting, and some other home goods. Automobile assemblies were up substantially in April as well.

According to preliminary data, orders placed with manufacturers of durable goods rose $0.4 billion, or 1.2 percent, in April to a level 17½ percent above that of a year earlier. This gain was concentrated in bookings for transportation equipment, as orders for aircraft and parts increased sharply. The rise in shipments of automobiles and trucks, which are counted as orders, also contributed to the advance in bookings for transportation equipment. New orders for producers' capital goods edged above their already high March level. In somewhat longer run perspective, bookings in almost all major market groups have exhibited healthy growth thus far in 1972. For example, in April orders for machinery and for producers' capital goods were 10 percent and 6½ percent, respectively, above their December 1971 levels. These increases tend to corroborate the acceleration in plant and equipment spending which has been indicated by several recent surveys. During the first quarter, net new capital appropriations of the 1,000 largest manufacturing firms rose sharply to their highest level in more than two years, according to the Conference Board survey. The May Department of Commerce survey of capital spending plans revealed that such investment was expected to increase by nearly 10½ percent in 1972. This was about in line with the results of their previous survey but below those of the most recent McGraw-Hill survey. Virtually all of the growth indicated by the latest Commerce De-

Chart I
INDUSTRIAL PRODUCTION
Seasonally adjusted; 1967=100



Source: Board of Governors of the Federal Reserve System.

partment survey was expected in the first half of the year, with capital spending expected to level off, on balance, during the final two quarters.

The improvement in durables orders in recent months tends to support the view that a more expansionary pace of inventory spending should materialize. As yet, however, there is little evidence of a quickening in the demand for inventories. For example, in the first quarter, the rise in inventory spending in the gross national product (GNP) accounts was a minuscule $0.6 billion.[1] Furthermore, preliminary data indicate a decline in the book value of total manufacturers' inventories in April, although the increase estimated for March was raised slightly. For all manufacturers, the ratio of inventories to sales slipped further in April to 1.59, as manufacturers' shipments increased moderately. This gain was concentrated in the durables sector, where shipments in almost all product groupings advanced. Despite the rise in durables shipments during April, the unfilled orders backlog climbed for the sixth consecutive month.

RESIDENTIAL CONSTRUCTION, PERSONAL INCOME, AND RETAIL SALES

Following the very strong performance of the December-February period, private housing starts declined in both March and April. The April decline of 242,000 units, about equally divided between single and multiunit construction, brought total starts to a volume of 2.1 million units at a seasonally adjusted annual rate. The April reduction may have been the result, in part, of an unusually small number of working days in the month relative to earlier years. In any event, April marked the twelfth consecutive month in which starts had exceeded 2 million units at an annual rate. Moreover, newly issued building permits halted a three-month slide in April and rose 3 percent to a seasonally adjusted annual rate of almost 2 million units.

Personal income increased by $4 billion in April to a seasonally adjusted annual rate of $910 billion, after rising by a similar amount in March and by $9 billion in February. The recent behavior of personal income has been affected by a variety of special factors, including retroactive payments of wage increases approved by the Pay Board, the Federal pay raise, and the increase in the social security tax base. Adjusting for the influence of these factors, personal income advanced by a fairly steady $5.5 billion per month over the February-April period. By comparison, the average monthly gain in personal income over the corresponding three months of 1971 was about $4.4 billion. Wage and salary disbursements accounted for most of the April gain, with a particularly significant advance occurring in manufacturing disbursements. Within manufacturing the durable goods sector provided much of the advance in payrolls, as gains were recorded in transportation equipment, machinery, electrical equipment, and fabricated metals.

Although April retail sales dropped below the record March level, the overall picture still looks strong. Estimates for both February and March have been revised up rather substantially. Furthermore, the average level of sales for the March-April period was about $1 billion, or nearly 3 percent, above that of the preceding two

[1] The first-quarter estimate of GNP has been revised, indicating that GNP increased by $30.7 billion to a seasonally adjusted annual rate of $1,103.6 billion. The rate of increase in the implicit GNP price deflator was revised downward slightly to an annual rate of 6 percent. The revised estimates reveal somewhat greater growth in real output—5.6 percent, compared with the 5.3 percent originally reported. Among the contributors to the upward revision in current-dollar GNP were business fixed investment and personal consumption expenditures. At the same time, the savings rate was revised down considerably to 7 percent. The preliminary estimates of corporate profits, released along with the GNP revisions, indicate that before-tax corporate profits rose $5.6 billion during the first quarter to $91.6 billion at a seasonally adjusted annual rate.

months. Sales of both durables and nondurables have shared in the gain. May sales of new domestic-type automobiles accelerated to a 9½ million unit seasonally adjusted annual rate, the fastest pace since last October when sales were stimulated by the price freeze. At the same time, sales of imported cars were at a 1.5 million unit annual rate, about the same rate that prevailed during most of 1971. Thus, for the month of May, total sales of new passenger cars were at a substantial 11 million unit annual rate—again, the highest monthly total since October 1971. The 13½ percent of the total that was accounted for by imports was somewhat below the 15 percent share they averaged during 1971.

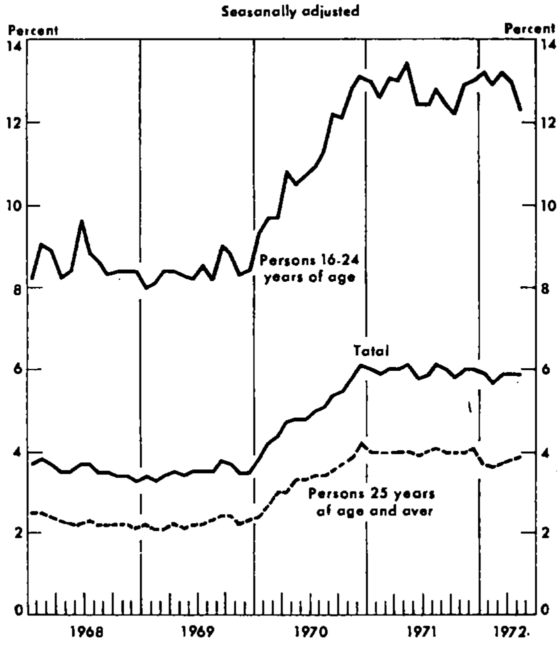
LABOR MARKET DEVELOPMENTS

Thus far in 1972, there has been a marked improvement in underlying labor market conditions. According to the Bureau of Labor Statistics survey of employers, nonfarm payroll employment rose by a seasonally adjusted 206,000 workers in May, bringing the gain in nonfarm payrolls since the beginning of the year to almost 1.3 million workers. Significantly, manufacturing employment—which was relatively hard hit by the recession and was slow to recover—has advanced considerably in 1972. After rising by an average of about 75,000 workers per month during the first four months of the year, manufacturing payrolls increased by an additional 92,000 workers in May. Moreover, these gains in manufacturing employment have been accompanied by significant increases in both the average factory workweek and hours of overtime since late last year.

Chart II

SELECTED UNEMPLOYMENT RATES

Seasonally adjusted



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

The unemployment rate remained at a seasonally adjusted 5.9 percent in May, essentially unchanged from its average of the past year and a half (see Chart II). To a considerable extent, however, the small fluctuations exhibited by this statistic have obscured recent, fundamental improvement in the labor market. The failure of the unemployment rate to show a larger decline, given the increase in employment, is attributable to a combination of factors that have resulted in very rapid labor force growth thus far in 1972. For example, over the six-month interval ended in May, civilian labor force growth amounted to a seasonally adjusted annual rate of 3.2 percent, whereas the long-term rate of increase in the labor force has been about 1.7 percent. In part, the rapid labor force growth is due to the larger than average expansion currently occurring in the population of labor force age. Beyond this, the continued reduction in the size of the armed forces has further swollen the ranks of the civilian labor force. At the same time, the increased availability of jobs has apparently stimulated a fairly sizable influx of new labor force entrants and reentrants.

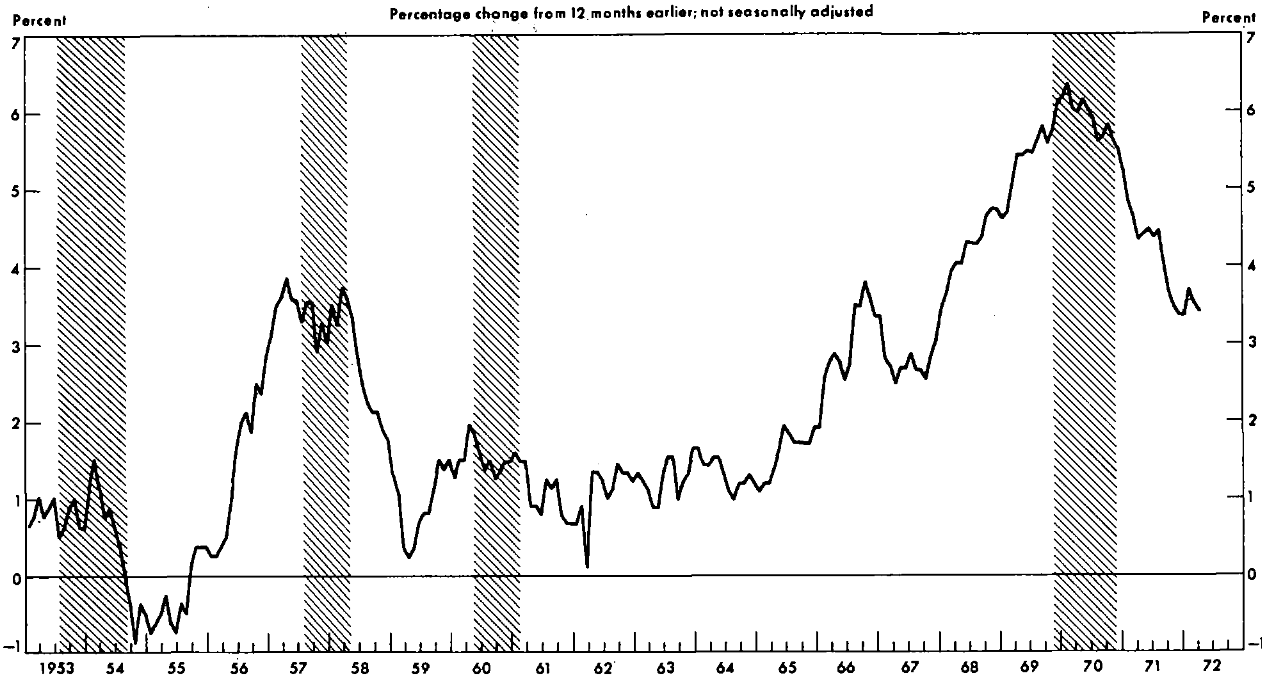
As noted above, one reason for the rapid growth of the civilian labor force has been the reduction in the armed forces. By May 1972, armed forces employment had declined by almost 240,000 from its level of December 1971. The influx of veterans, many of whom are less than twenty-five years of age, has also contributed to the growing concentration of unemployment among younger workers. Data on the age composition of the unemployed reveal that, on balance, teen-agers and young adults (workers of sixteen to twenty-four years of age) have comprised a greater percentage of total unemployment in 1972 than they did over most of last year, while adults (twenty-five years of age and older) have made up a smaller proportion of the unemployed. This suggests that a relatively higher proportion of adult workers has been absorbed by the expansion in employment.

Further along these lines, data published by the Bureau of Labor Statistics on the distribution of the unemployed by reason of joblessness indicate a similar shift in the composition of unemployment. Thus far in 1972, a noticeably greater proportion of total civilian unemployment

Chart III

CONSUMER PRICE INDEX

Percentage change from 12 months earlier; not seasonally adjusted



Note: Shaded areas represent recession periods, according to the National Bureau of Economic Research chronology.
The dates of the 1969-70 recession are tentative.
Source: United States Department of Labor, Bureau of Labor Statistics.

has stemmed from new labor force entrants—and to some extent reentrants—than was the case during 1971; concomitantly, the proportion of those unemployed because of loss of previous job has fallen below 1971 levels. For example, in December 1971 new entrants and reentrants together accounted for 41½ percent, on a seasonally adjusted basis, of total unemployment, while persons who had lost their jobs comprised 45½ percent. The corresponding figures for May of this year were 44 percent and 43 percent, respectively, indicating that the relative contribution of these groupings was reversed. In combination, these compositional shifts suggest that new, young entrants into the labor force, rather than job losers, have played an increasingly important role in sustaining the relatively high unemployment rates recently prevailing. Additional evidence of this is provided by the behavior of the state-insured unemployment rate which, unlike the total unemployment rate, has fallen well below 1971 levels in recent months. The performance of the state-insured rate largely reflects the reduction in the percentage of job losers among the unemployed for, in most instances, only persons who have lost their jobs are eligible for state unemployment insurance benefits. However, it should be noted that the decline in the insured unemployment rate may also reflect the exhaustion of benefits by some of the unemployed, as suggested by the recent increase in the ranks of those unemployed for twenty-seven weeks or longer.

Average hourly earnings of production and nonsupervisory workers in the private nonfarm economy, adjusted for overtime hours in manufacturing and for shifts in the composition of employment among industries, rose at a 3.5 percent seasonally adjusted annual rate in May, down from the 6.2 percent rate of increase in earnings in the previous month. Since the end of the wage freeze, this index, boosted by exceptionally large gains in December and January, has climbed rapidly at an annual rate of 7½ percent. However, over the four months since January, the increase in average hourly earnings has been at a more moderate 4.7 percent annual rate, whereas, during 1970 and the first eight months of 1971, earnings rose at about a 7 percent annual rate. While these recent data suggest some diminution in wage pressures, following the initial post-freeze bunching of increases, it is still too early to conclude that a fundamental and significant slowing in wage gains is under way.

RECENT PRICE DEVELOPMENTS

The most recent readings on consumer and wholesale prices remain mixed. The pace of advance in consumer prices appears to have slowed considerably, as the index, seasonally adjusted, climbed at a relatively modest 2 percent annual rate in April, after displaying little change in March. With the exception of the months covered by the price freeze, this marked the slowest increase in consumer prices over two consecutive months since early 1967. Overall, in Phase Two thus far, consumer prices have climbed at an annual rate of 3.3 percent, somewhat below the pace of the first eight months of 1971 and strikingly below the advances registered in each of the preceding three years, when consumer prices rose annually between 4.7 percent and 6.1 percent (see Chart III).

The April rise in the consumer price index resulted from relatively moderate increases in prices of nonfood commodities and services; on the other hand, retail food prices declined. Among the nonfood commodity groups, some individual product prices—such as prices of used cars and men's clothing—moved up appreciably, as did service charges for electricity and property taxes. The latter two groups of prices have been a significant source of upward pressure on the overall consumer price index for many months. Food prices, which had surged sharply in several recent months, decreased at a 1 percent seasonally adjusted annual rate after holding steady in March. Moreover, the decline in food prices was rather broadly based, with prices of beef and veal falling for the first time since November. On the other hand, in light of the sharp increase in May in prices of farm products and processed foods and feeds at the wholesale level, it is likely that renewed upward pressures on consumer food prices will emerge in coming months.

The advance of overall wholesale prices accelerated in May to a seasonally adjusted annual rate of 5.4 percent, up from the 2.4 percent rate of increase experienced on average during the previous two months. Since the termination of the price freeze last November, wholesale prices have climbed at a 5.1 percent annual rate, or at about the same pace as during the first eight months of 1971. Industrial wholesale prices increased at a 4.2 percent annual rate in May, about the same disappointingly rapid pace of the previous five months. Prices of hides, skins, leather, and related products and prices of lumber and wood products continued to advance sharply in May, contributing significantly to the persistent rise in industrial wholesale prices.