The Business Situation

Economic activity has continued to exhibit powerful upward momentum in recent months. Real gross national product (GNP) climbed at an annual rate of nearly 8 percent in the first quarter, bringing real growth over the past four quarters to this same very rapid pace. Personal consumption expenditures grew more rapidly in real terms than at any other time in the past twenty-one years, except for the first quarter of 1971 when spending was rebounding from an automotive strike. Business fixed investment continued very strong, and the latest private survey of investment intentions indicates that business firms plan further large outlays for plant and equipment during the remainder of the year. It is also likely that firms will attempt to step up the rate of inventory accumulation in coming months. Total civilian employment leveled off in April following a large first-quarter increase, but employment in manufacturing as well as the average workweek and overtime in that sector continued to rise.

The price situation has deteriorated seriously in recent months. The fixed-weight price index for GNP increased at a 7.5 percent annual rate in the first quarter, nearly twice the rate of advance experienced over the year 1972. Wholesale prices of farm and food products soared during the first quarter, on the heels of an already very rapid fourth-quarter advance. Although these prices finally leveled off in April, recent widespread storm and flood conditions may reduce supplies and thus cause further upward price pressures. Consumer food prices have already reflected the runup of wholesale farm prices, climbing sharply over the first three months of the year. Moreover, shortages of a wide variety of industrial commodities have begun to materialize, and prices of some such products have risen markedly at the wholesale level in recent months. These increases will undoubtedly be reflected in prices of consumer and other finished goods in the months to come.

GROSS NATIONAL PRODUCT AND RELATED DEVELOPMENTS

Preliminary estimates prepared by the Department of Commerce indicate that the total market value of the nation's output of goods and services rose $40.6 billion in the first quarter, a 14.3 percent seasonally adjusted annual rate of gain. While a substantial part of this growth was accounted for by price increases, real GNP expanded strongly at a 7.9 percent annual rate during the first quarter, following a similar advance in the preceding quarter. Indeed, since the first quarter of 1972, real output increased by 7.9 percent, the most robust four-quarter advance in seven years (see Chart I).

The rapid growth of GNP in the first quarter was accompanied by an apparent slackening in the rate of inventory accumulation. Based on incomplete data, inventory investment in GNP terms is estimated to have been at a seasonally adjusted annual rate of $7.9 billion in the January-March period, $2.4 billion below the rate of the preceding quarter. To a considerable extent this slowing may have been unintentional—the result of exceptionally strong sales. In any event, the ratio of the book value of inventories to sales for the trade and manufacturing sectors remained at a very low level in February (the most recent month for which data are available), suggesting that further advances in inventory spending are likely in coming quarters.

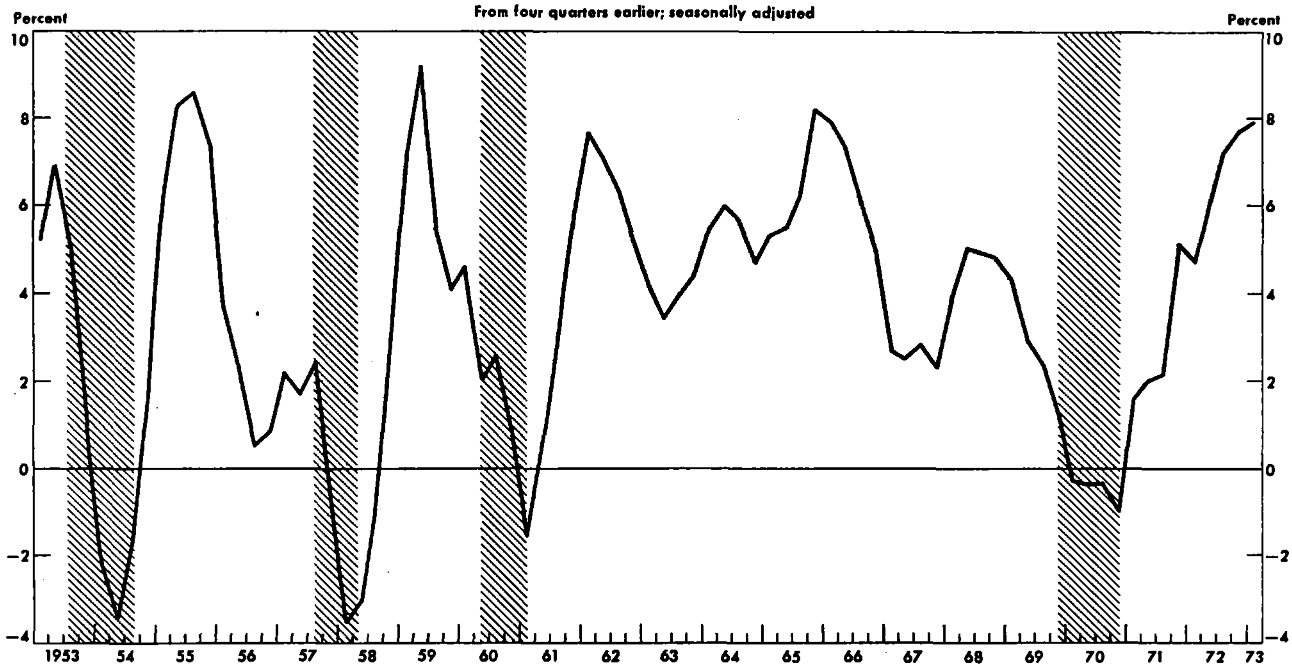
The first-quarter increase in current-dollar final expenditures—GNP net of inventory accumulation—amounted to a very strong $43 billion (see Chart II), or 15.3 percent at an annual rate. In real terms, final spending rose at a 9.1 percent annual rate, somewhat above the gain in the preceding quarter. The growth in final spending was particularly strong in personal consumption expenditures and business fixed investment. Outlays for new residential construction and government expenditures also contributed to the growth in final expenditures.

Personal consumption expenditures rose $28 billion in the first quarter. In real terms, the percentage growth in consumption expenditures was the largest in the past two decades, except for a similar rate of advance in the first quarter of 1971, when such spending was buoyed by the upsurge in economic activity associated with the end of an automotive strike. Outlays for both durable and nondurable goods surged ahead vigorously during the first quarter (see Chart II). Consumer spending in the current

Chart I

PERCENTAGE CHANGES IN REAL GROSS NATIONAL PRODUCT

From four quarters earlier; 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 Commerce, Bureau of Economic Analysis.

quarter may be bolstered by the substantial volume of tax refunds resulting from the overwithholding of personal income taxes last year. On the other hand, the outlook for further sizable gains in spending is clouded by an apparent deterioration in consumer confidence found by recent surveys. These surveys indicate a resurgence of fears of inflation as well as increased concern over the outlook for business conditions and employment.

The rapid advance in consumer spending was accompanied by a healthy $19.3 billion increase in personal income. It would have been about $5 billion larger had it not been for an increase in the rate of social security contributions at the beginning of the year. The primary source of the advance in personal income was the rise in wage and salary disbursements which, in turn, reflected large gains in employment. At the same time, the rate of savings out of disposable income fell to 6.7 percent from 7.6 percent in the fourth quarter. Notwithstanding this decline, the first-quarter savings rate remained above its levels of the second and third quarters of 1972.

Business fixed investment climbed by $6.2 billion in the January-March period, reflecting strong advances in outlays for both producers' durable equipment and structures. Nevertheless, the Federal Reserve Board's index of capacity utilization rose again for the fifth consecutive quarter. The indicated reduction in the margin of idle productive capacity, together with rising new orders for durable manufactured goods and a mounting backlog of unfilled orders, suggests that investment expenditures are likely to remain robust for some time to come. This conclusion is also supported by the substantial upward revision in planned capital spending reported in the most recent survey of investment intentions. According to the latest McGraw-Hill survey, business firms plan to raise their outlays for plant and equipment in 1973 by 19 percent. If realized, this would be the largest increase in capital spending since 1956.

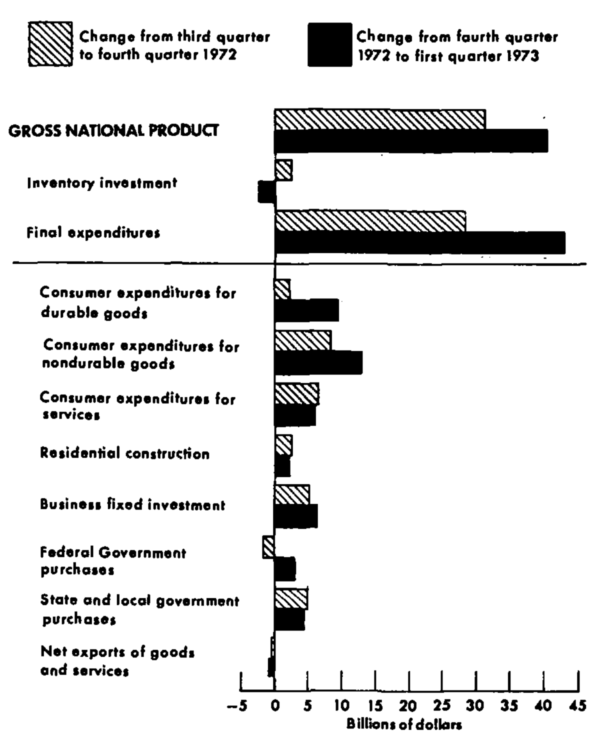
The prolonged expansion in residential construction persisted in the first quarter, as such expenditures increased by $2.2 billion over the fourth-quarter level. Housing starts held at a high annual rate of 2.4 million units in the January-March interval, the same as in the preceding three-month period. Nevertheless, there are tentative signs that housing activity is beginning to taper off. In March, starts fell to their lowest level in eight months, and newly issued building permits declined in each month of the first quarter. Moreover, the ratio of unsold new homes to sales of new one-family homes continued to climb during the first two months of the year (the latest data available), suggesting the possibility of some overbuilding.

Government purchases of goods and services contributed $7.5 billion to the first-quarter GNP advance. Federal spending increased by $3 billion, rebounding after two quarters of decline. At the state and local levels, spending rose $4.6 billion, slightly below the fourth-quarter increase.

Chart II

RECENT CHANGES IN GROSS NATIONAL PRODUCT AND ITS COMPONENTS

Seasonally adjusted



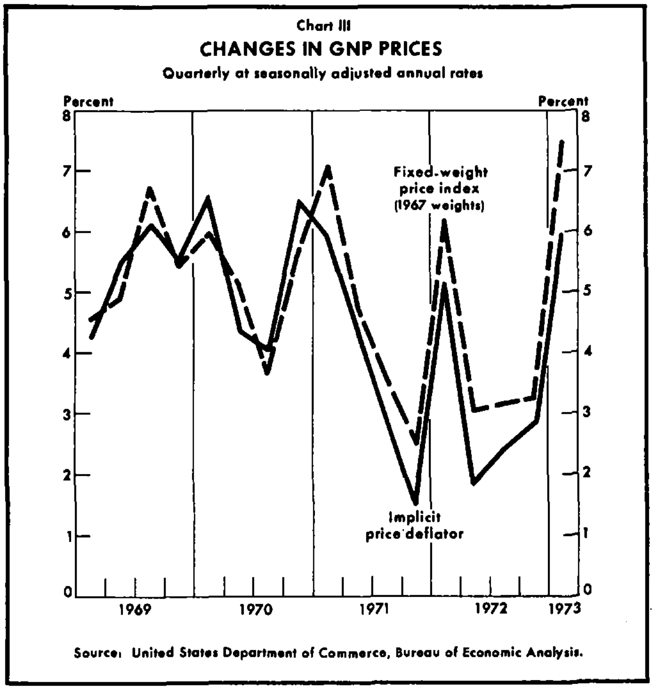
Source: United States Department of Commerce, Bureau of Economic Analysis.

PRICE DEVELOPMENTS

The price situation has deteriorated markedly in recent months. The first-quarter price data probably exaggerate underlying inflationary pressures, since some increases that might otherwise have been distributed over time were bunched together in the transition from Phase Two to Phase Three price and wage controls. Nevertheless, a serious inflationary problem is clearly evident. The largest recent price increases have taken place in sectors experiencing obvious demand pressures, such as fuel, or in highly competitive industries where prices tend to reflect current demand conditions sensitively. Examples of the latter include agriculture, lumber, many nonferrous metals, and textiles. These factors, together with increasing reports of shortages and lengthening delivery times, make it apparent that demand pressures are once again contributing significantly to inflation. On May 2, the Administration announced that corporations whose annual sales exceed $250 million would be required to notify the Cost of Living Council thirty days in advance of price increases that would raise their average weighted prices more than 1.5 percent above the January 10 levels.

The most familiar comprehensive measure of price behavior, the implicit GNP price deflator, advanced at a 6 percent seasonally adjusted annual rate in the first quarter (see Chart III). This rise was more than double that registered in the preceding three-month interval and represented a marked acceleration from the rate of increase in the last three quarters of 1972. The implicit price deflator, however, is affected by shifts in the composition of output among different goods and services. Therefore, the Department of Commerce also computes a fixed-weight price index based on the composition of spending in 1967. This index has consistently shown higher rates of inflation than has the implicit GNP deflator since the beginning of 1971, largely because declining Federal employment has reduced the weight of Federal Government employee compensation in total GNP. Since the deflator for Federal employee compensation is high relative to the average deflator for total GNP, the decrease in the weight of this item has tended to hold down the overall deflator. In the first quarter of 1973, moreover, the composition of spending shifted in favor of some items whose prices have risen less than the overall price level since the base year 1967. These include automobiles, trucks, appliances, and furniture. The fixed-weight GNP price index rose in the first quarter at a 7.5 percent annual rate, which was also more than double the rate of the previous quarter.

Consumer prices rose at a seasonally adjusted annual rate of 10 percent in March, with food continuing to be in



the forefront. Over the first quarter, consumer prices increased at an annual rate of 8.8 percent, compared with 3.2 percent in the preceding quarter. During the January-March period, prices of nonfood commodities moved ahead at a 3.4 percent annual rate, well above the increase in the two preceding quarters. Food prices, however, shot upward at an annual rate of nearly 30 percent, compared with 5.2 percent in the fourth quarter of 1972.

Wholesale prices of industrial commodities advanced very rapidly in April at a 17 percent seasonally adjusted annual rate, following a first-quarter increase at a 10.3 percent rate. April marked the fourth successive month in which the rate of increase of such prices had accelerated. The advances in industrial prices during these months were broadly based among a variety of commodities. Prices of farm products and processed foods and feeds leveled off in April after an extraordinary 53 percent seasonally adjusted annual rate of increase in the first quarter.

WAGES, PRODUCTIVITY, COLLECTIVE BARGAINING AGREEMENTS, AND EMPLOYMENT

In the first three months of 1973, compensation per hour of work in the private economy is estimated to have increased at an 11.8 percent annual rate, well above the 6.6 percent rate of advance for 1972 as a whole. Much of the increase in first-quarter compensation growth over the pace of the fourth quarter was attributable to increases in social security taxes paid by employers. Both the tax rate and the wage base were increased in January. Average hourly earnings of production and nonsupervisory workers rose only moderately during the first two months of the year but more rapidly in March and April.

Productivity continued to advance strongly in the first quarter. Reflecting an especially large gain in agricultural productivity, output per hour worked in the private economy increased at a 4.6 percent annual rate in the first quarter. This was very close to the average gain in 1972 as a whole and was well above the longer run annual increase of 3 percent averaged over the past two decades. The first-quarter improvement in productivity in the private nonfarm sector was somewhat less impressive. The 3.9 percent annual rate of gain in output per hour worked in that sector fell short of the 5.2 percent increase in 1972 but nevertheless remained well above the longer run average. With the very rapid increase in compensation per hour, labor costs per unit of output in the private economy climbed at a 6.8 percent annual rate, the fastest quarterly rise in over two years.

The latest Bureau of Labor Statistics survey reveals further moderation in the rate of increase in wages and benefits under major collective bargaining agreements during the first quarter. Over all industries, settlements approved during the first three months of this year provided for mean life-of-contract wage and benefit increases of 5.5 percent, down from 7.3 percent for all of 1972. The bargaining schedule in the first quarter was rather light, however, with major collective bargaining settlements (those involving at least 5,000 workers) covering only about 600,000 workers. Larger wage increases may well emerge from the heavy schedule of collective bargaining agreements to be negotiated in coming months.

Civilian employment leveled off in April following a large first-quarter gain of 1.1 million workers, seasonally adjusted, according to the Department of Labor's survey of households. Similarly, the civilian labor force changed little in April following a large increase in the first quarter. Consequently, the rate of unemployment in April remained at the first-quarter average of 5 percent. The separate survey of establishments indicated a continued rise in nonagricultural payroll employment in April, with the advance centered primarily in manufacturing. The average workweek in manufacturing climbed further in April by 0.2 hour to 41.1 hours, the highest in over six years. Average overtime in manufacturing rose an additional 0.2 hour to 4.1 hours, also the highest since 1966.