The Business Situation

Recent business statistics have continued to indicate some slowing in the economy's rate of growth, although continued strength is expected in some key sectors. Industrial production has declined in each month since July, and residential construction activity has fallen since the beginning of 1969. In addition, consumer buying has been sluggish, and November retail sales were little changed from the levels of last spring. The price picture, however, shows no real slowing in rates of increase, and recent wage settlements are bound to result in significant boosts in unit wage costs. The outlook for the economy is rather mixed. Housing has been under downward pressure as a result of tight financing conditions, and auto production schedules have been cut back. Nevertheless, enactment of the tax reform bill, which includes a cut in the surcharge rate from 10 percent to 5 percent for the first six months of 1970 and elimination of the surcharge thereafter as well as an increase in social security benefits, will have a strongly stimulative influence on consumer income. Furthermore, most recent capital spending surveys point to rapid increases in plant and equipment purchases well into 1970.

PRODUCTION AND CONSTRUCTION

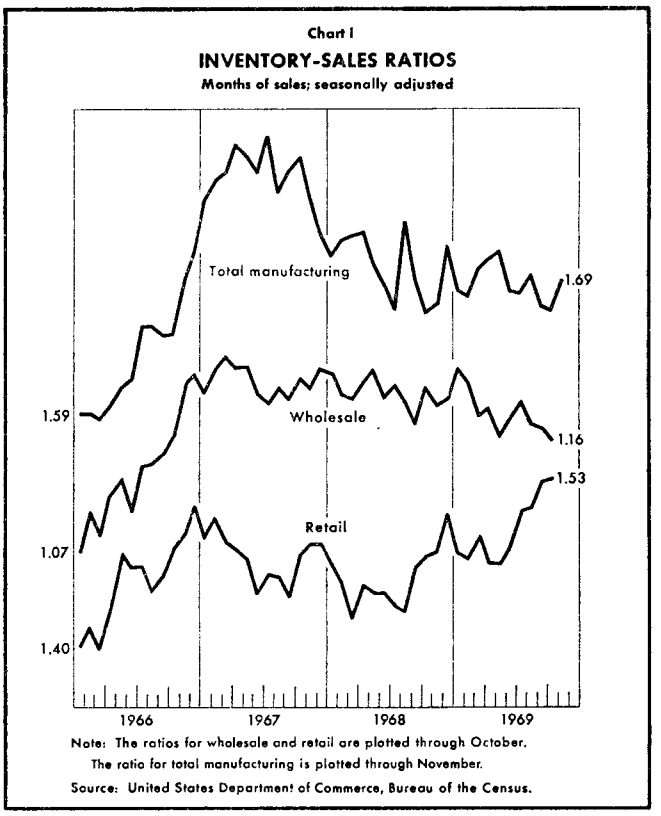
The Federal Reserve Board's index of industrial production declined in November for the fourth consecutive month, dropping by 1.2 percent to a seasonally adjusted level of 171.1 percent of the 1957-59 average. This was the largest monthly decline since the 1960 recession, but approximately one half of the November fall was attributable to the strike of about 150,000 workers at the General Electric Corporation. The cumulative decrease in output from the July peak amounts to about 2 percent, approximately the same percentage decline that had occurred in the first quarter of the 1967 mini-recession.

The General Electric strike had its major impact in the business equipment sector, where output fell in November after expanding at an annual rate of almost 7 percent in the first ten months of 1969. In view of the strength of near-term capital spending plans, however, growth of output in this sector could well return to a rapid pace after settlement of the strike. After edging down from July to October, the production of materials registered a sizable decline in November. This largely reflected reductions in output of electronic components (General Electric) and auto parts included in the materials index. Iron and steel output, which grew rapidly in the first half of 1969, has remained about constant at the level it fell to in August. While seasonally adjusted data on steel ingot production indicate that output in December was up slightly, iron and steel industry observers say that production may soon be cut in response to reduced demand from the auto sector.

Consumer goods output fell 0.7 percent in November chiefly because of a large drop in the output of automotive products. Several major auto producers cut overtime and shut down for several days in order to reduce inventories. On a unit basis, car assemblies dropped off sharply from a seasonally adjusted annual rate of 8.4 million in October to 7.9 million in November. Moreover, General Motors and Chrysler had additional shutdowns in December, and total domestic auto assemblies on a seasonally adjusted basis declined further to 7.2 million units. First-quarter 1970 production schedules of these two producers have also been cut back. The General Electric strike was another important factor in the November decline of consumer goods production.

Residential construction has been under severe downward pressure, as mortgage market conditions have become steadily tighter. Private nonfarm housing starts in November at 1.27 million housing units, on a seasonally adjusted annual basis, were almost 15 percent below the 1968 average. Starts in all types of housing and in all regions except the South decreased in that month. The short-term outlook is for continued downward pressure on the residential construction sector. The number of newly

issued local building permits for private housing units has dropped at about the same percentage rate as actual housing starts: the November level was almost 14 percent below the 1968 average; in addition, the dollar value of residential construction contracts, as reported by F. W. Dodge, dropped in November and the average level from June to November was 10 percent below the average in the first half of 1969. However, the increase in the legal ceiling rate on mortgages insured by the Federal Housing Authority and those guaranteed by the Veterans Administration from 7½ percent to 8½ percent, combined with a large backlog of unutilized building permits, may have a favorable effect on housing starts in the forty states that do not have legal maximum interest rates applicable to Government-backed mortgages.



ORDERS, INVENTORY ACCUMULATION, AND CAPITAL SPENDING

New orders received by manufacturers of durable goods have, on the average, been trending upward, although during 1969 the growth rate was somewhat less rapid than in 1967 and 1968. Moreover, since prices have risen substantially, the 1969 increase in the volume of orders in real terms has been considerably less than the increase in dollar volume. In November the orders series fell $0.7 billion despite an increase of $0.3 billion in defense bookings. Monthly figures are often volatile, but November declines were widespread, with electrical machinery, auto, and primary metals manufacturers experiencing exceptionally large reductions in the inflow of orders.

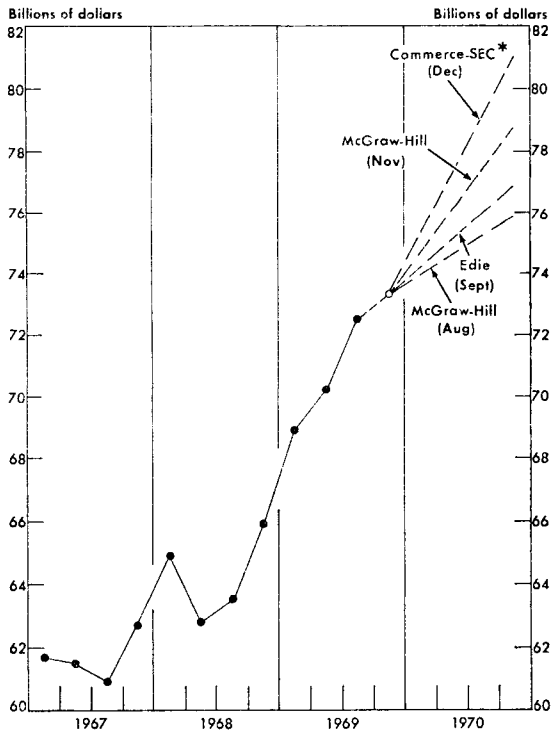
Although total business inventories have been rising at rates which appear pretty much in line with total sales growth, this has not been true for all sectors (see Chart I). In October, total manufacturing and trade inventories advanced $1.4 billion, with both manufacturing and retail levels continuing their rapid rates of accumulation. At the manufacturing level, there was a sizable increase in sales and the inventory-sales ratio registered a slight decline. November data on the manufacturing sector, however, indicate that sales fell 1 percent entirely because of a decline in durables shipments. Meanwhile, inventories rose $450 million, again all in the durables category, and the inventories-sales ratio increased but remained well within the range of recent years. Moreover, at the wholesale level, inventory accumulation has been negligible and the inventory-sales ratio has been relatively low lately. Data for retail stores in recent months, however, suggest some imbalance between inventories and sales. For both durables and nondurables retailers, inventories since the summer have been greater, relative to sales, than in the past few years. In the auto industry, where sales have been particularly weak, dealers' stocks have been rising at a fast pace since July, and the inventory-sales ratio for other durables is higher than at the beginning of 1969. At retail outlets for nondurable goods the October surge in sales caused a fairly significant drop in the inventory-sales ratio, but the ratio still suggests the existence of surplus inventories.

Despite falling profits and exceptionally tight conditions in money and capital markets, businessmen are currently undertaking and planning for enormous amounts of plant and equipment investment. The Department of Commerce and the Securities and Exchange Commission revised upward their estimate of fourth-quarter plant and equipment expenditures, and an increase from the third quarter is now indicated rather than the leveling expected earlier. According to this estimate, plant and equipment spending in 1969 was $71.3 billion, 11.2 percent above the 1968 rate. Furthermore, as the end of 1969 approached, successive surveys of capital spending have tended to forecast increasingly higher plant and equipment outlays for 1970 (see Chart II). In August, the McGraw-Hill survey pro-

jected 1970 expenditures of $74.9 billion. Lionel D. Edie & Co., Inc. estimated, in September, that 1970 expenditures would average $75.5 billion. In October, the McGraw-Hill fall survey reported business plant and equipment purchases of $76.7 billion for 1970, and in December the latest Commerce-SEC survey projected $78.1 billion for 1970, a 9.7 percent increase over the 1968 level. An earlier Commerce-SEC report indicated that growth in the first half of 1970 would be particularly strong. While some of the increase in expenditures will undoubtedly be absorbed by the higher prices that are anticipated, this estimate nevertheless implies that plant and equipment purchases in real terms will be substantially above the boom levels of 1969. According to McGraw-Hill, the advance in real spending reflects businessmen's desires to cut steeply rising unit production costs by modernization as well as their carryover of some unfulfilled 1969 plans into 1970. Of course, not all sectors are planning equally large expenditure increases. Commerce-SEC indicated that it was the nonmanufacturing sector that was planning a more rapid expansion, with public utilities—currently under severe capacity constraints—planning a 15 percent annual jump in plant and equipment expenditures. In the manufacturing sector, purchases are expected to rise at a slower rate than they did in 1969, but record-level investment spending will still be undertaken. While manufacturers appear to have ample capacity, they report expectations of fast demand growth in 1970 and thereafter.

Chart II

ACTUAL AND ANTICIPATED PLANT AND EQUIPMENT SPENDING



*The November Commerce-SEC survey indicated that most of the growth is slated for the first half of the year rather than being spent evenly throughout the year as shown in this chart.

Sources: United States Department of Commerce, Securities and Exchange Commission, McGraw-Hill, Inc., and Lionel D. Edie & Co., Inc.

EMPLOYMENT, PERSONAL INCOME, AND RETAIL SALES

Although the unemployment rate in November and December at 3.4 percent was close to record-low levels, other indicators suggest some easing in labor market conditions. In November the percentage of covered persons receiving unemployment insurance benefits rose and the index of help-wanted advertising fell. The decline in average hours worked also suggests eased conditions: the average workweek for factory workers fell 0.3 hours to 40.5 hours in October and edged up slightly in December, while overtime hours in November were down for the second consecutive month. Furthermore, according to the payroll survey, employment has been growing more slowly in recent months. Nonagricultural employment, which was increasing at the fast rate of 238,000 persons per month during the first half of the year, has been rising by only 57,000 persons per month since June.

Personal income has been growing at a considerably slower rate in recent months, reflecting major work stoppages as well as easier labor market conditions and declining corporate profits. In the first half of 1969, personal income increased at an annual rate of 8½ percent, whereas since June the rate has been about 6½ percent. During November the General Electric strike reduced incomes by $1 billion and the net rise in total personal income was only $3.2 billion. However, even after adjustment for the effects of the strike, there appears to have been some slowing of the growth rate in October-November. Lately wage and salary income increases, in particular, have moderated, as gains in the number of payroll jobs have become smaller and the average workweek has fallen.

Another indication of slowing in the economy is the volume of retail sales, which has shown no significant change since the spring. Sales rose 1 percent in October, then declined a bit to $29.5 billion in November, a level only about ½ percent above that registered in the spring. Since December 1968, dollar volume has increased only 4.2 percent, less than the 5 percent rise in consumer goods

prices. While the dollar volume of nondurables sales was about constant in November, durables sales turned down, with almost all the decline attributable to a fall in automotive group sales. On a seasonally adjusted annual basis, domestic new car sales were 8.3 million units in November, down from 8.4 million in October, and the data show a further decline in new car sales to 7.7 million units in December. Preliminary December data for total retail sales indicate little change from November. The outlook for consumer demand is unclear. While the Michigan Survey Research Center reported the third consecutive quarterly decline in the index of consumer sentiment, the new tax and social security provisions will certainly bolster consumer income and perhaps also consumer eagerness to buy.

Despite the current slowing of economic expansion, prices have continued to increase rapidly at both consumer and wholesale levels. Consumer price rises have been excessively large, averaging 6.0 percent (annual rate) in 1969 through November as compared with 4.7 percent in 1968 and 3.1 percent in 1967. There appears to be no real slowing of price increases, although some comparisons may suggest a moderation. From June to November, the consumer price index has risen at an average annual rate of 5.5 percent, lower than the 6.3 percent rate experienced in the first half of 1969. The average annual rate of price increase in the last six months for which data are available (May through November), however, is about the same as in the first five months of 1969. Moreover, consumer prices were rising at a 6.5 percent rate in November.

At the wholesale level, also, recent price advances have been large. Wholesale industrial prices rose at a 4.2 percent annual rate in December, resulting in an average annual rate of change in prices of 4.9 percent during the fourth quarter of 1969. The overall rise in 1969 was 4.0 percent, compared with 2.6 percent in 1968 and 1.8 percent in 1967.

Meanwhile, rising wages and lagging productivity continue to put upward pressure on prices. In the manufacturing sector, labor cost per man-hour rose at an annual rate of almost 4 percent in November, while output per man-hour fell 4 percent; hence, the labor cost of producing a unit of output increased at an annual rate of 8 percent. Rapid rises in the labor cost of production have been common in recent months: from June to November, unit labor cost in manufacturing increased at a rate of 7 percent, compared with only 2 percent in the first half of 1969. Moreover, recent and prospective large wage settlements will undoubtedly result in a significant rise of unit labor costs in 1970.

The Business Situation

The nation's real output of goods and services was virtually unchanged in the fourth quarter of 1969, although price increases raised the market value of that output by more than $10 billion. The latest monthly figures point to continued slackening of economic activity. Industrial output declined in December, maintaining its steady downtrend from the July peak, new orders for durable goods registered a third consecutive monthly decrease, and housing starts fell still lower. Total retail sales in December were essentially unchanged, while successive declines have brought new domestic auto sales to the lowest level in two years, inducing the major producers to make sharp cuts in production. The lack of growth in real gross national product (GNP) in the past quarter has been reflected in slightly higher unemployment but not in any slowing in the rate of price inflation, and wage increases continue to far outstrip productivity rises. Furthermore, consumer purchasing power has been boosted by reduction of the surtax to 5 percent, social security benefit checks will shortly be increased, and the surtax is scheduled to be eliminated in July. In addition, surveys indicate record business capital spending plans for 1970 despite falling corporate profits and tight conditions in the financial markets. A major uncertainty is the extent of fiscal restraint to be achieved this year; it will take a determined effort by the Administration and the Congress to limit the rise of Federal spending.

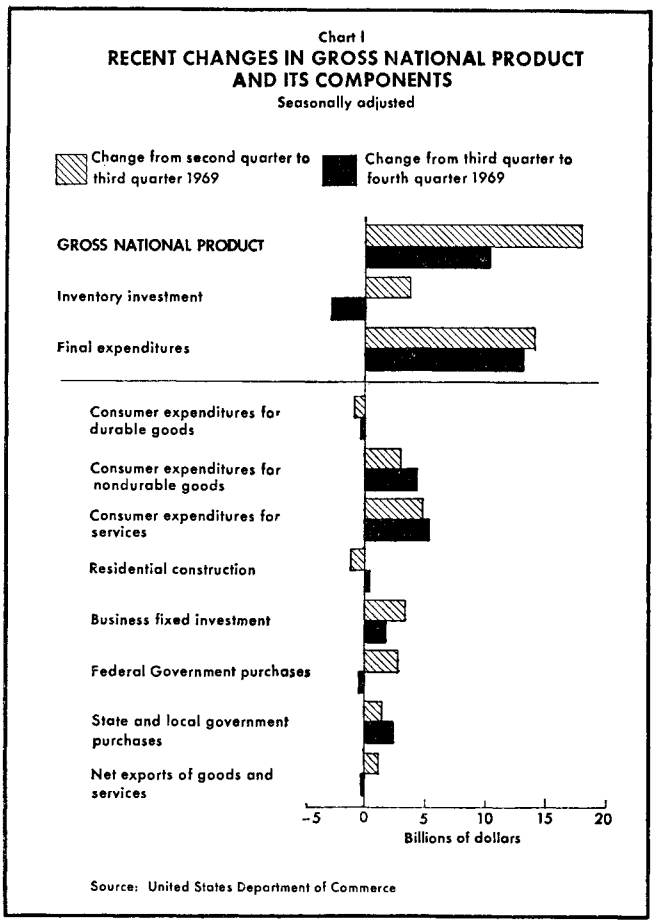
GROSS NATIONAL PRODUCT

The nation's total output of goods and services as measured in constant dollars failed to rise in the fourth quarter for the first time since the mini-recession of 1967, according to preliminary estimates. The market value of GNP rose $10.3 billion (see Chart I) to a seasonally adjusted annual rate of $953.1 billion as the result of price increases. This was the smallest quarterly advance of the year and was partly due to the General Electric strike. In the GNP accounts, most of the slowdown was in the amount of inventory accumulation.

The fourth-quarter decline of $2.9 billion (preliminary) in inventory accumulation was not an unusually large drop and was certainly nothing like the abrupt $10.9 billion swing that marked the first quarter of 1967. (The fourth-quarter preliminary GNP inventory figure is based upon October and November inventories, since December data were not yet available.) On balance, the inventory situation toward the end of 1969 did not show broad-based excesses of the sort which preceded the 1967 mini-recession, although there is evidence of surpluses in some sectors. Durables manufacturers' inventories have been building up recently as sales growth has slackened. In November, inventories of durables manufacturers rose $445 million, while sales fell almost $1 billion; as a result the inventory-sales ratio jumped 3.8 percent, with both auto and nonauto durables manufacturers experiencing increases. Nondurables manufacturers experienced a modest rise in inventories and a small decline in sales, but total inventories did not appear to be excessive. At the retail level, markedly lower inventory accumulation at durables outlets resulted mainly from a reduction in inventory growth at auto dealers. Outlets for other durables and nondurables, however, experienced moderate-sized gains in November in the face of sluggish sales, and their already high inventory-sales ratios increased substantially. December data on the manufacturing sector indicate another sharp drop of $1 billion in durables sales. Meanwhile, durable goods inventories continued to rise, although at a reduced rate, and the inventory-sales ratio increased to the highest level since 1967.

The growth of GNP less inventory change (final expenditures) in the fourth quarter amounted to $13.2 billion, only two thirds the first quarter of 1969. The quarterly advances of final expenditures were successively less throughout 1969 and, by the end of the year, most components' growth rates were distinctly weaker.

While fourth-quarter consumption expenditures rose $9.4 billion, compared with a $7.0 billion advance in the third quarter, the increase was considerably less strong than in the first two quarters, mainly because of a reduction in the purchase of durables. The retail sales figures also indicate lackluster consumer demand. Retail sales, sluggish since the spring of 1969, were essentially unchanged in December. Over the twelve months of 1969,



dollar sales grew only 3.4 percent, while consumer goods prices rose 5.5 percent, suggesting about a 2 percent fall in real sales volume. Approximately half the decline occurred during the fourth quarter of the year, when dollar sales were growing more slowly and prices rising more rapidly than on average during 1969. In particular, unit sales of domestic cars have shown substantial softening. On a seasonally adjusted annual basis, unit sales fell from 8.3 million in November to 7.7 million in December, and in January declined to 6.8 million.

Business fixed investment registered only a relatively small advance in the fourth quarter, increasing $1.9 billion as compared with $3.3 billion in the previous quarter. This slowdown had been previously estimated by Department of Commerce and Securities and Exchange Commission surveys of business spending plans. Capital spending surveys also indicate that in the first half of 1970 the annual growth rate of plant and equipment expenditures could be 13½ percent, about the same as during 1969 on the whole and considerably above the fourth-quarter rate.

The near-term outlook for residential construction, however, is for further moderation. Although residential construction in dollar terms actually rose slightly in the fourth quarter after dropping in the second and third quarters, this reflected home repairs and modernization rather than new building. Recent monthly statistics on housing starts have shown steady declines, as individuals have found growing difficulty in obtaining mortgage financing. Private nonfarm housing starts fell 3 percent in December to a seasonally adjusted annual rate of 1.24 million—the lowest level since December 1967. On the average, starts in the fourth quarter of 1969 were at a seasonally adjusted annual rate of 1.30 million units, 23 percent below the average during the first quarter of 1969. Moreover, in November and December, declines in housing activity occurred in the western part of the country, where usury ceilings are generally higher and home building had been relatively strong. The number of newly issued building permits authorizing new private housing units has been declining, and during the last quarter averaged a full 17 percent less than in the first quarter of 1969. The fall in starts and permits took place despite substantial advances to savings and loan associations by the Federal Home Loan Bank Board (FHLBB) and purchases of insured mortgages in secondary markets by the Federal National Mortgage Association. The recent action of the FHLBB permitting savings and loan associations to raise interest rates paid on all types of accounts may reduce the rate of deposit outflow.

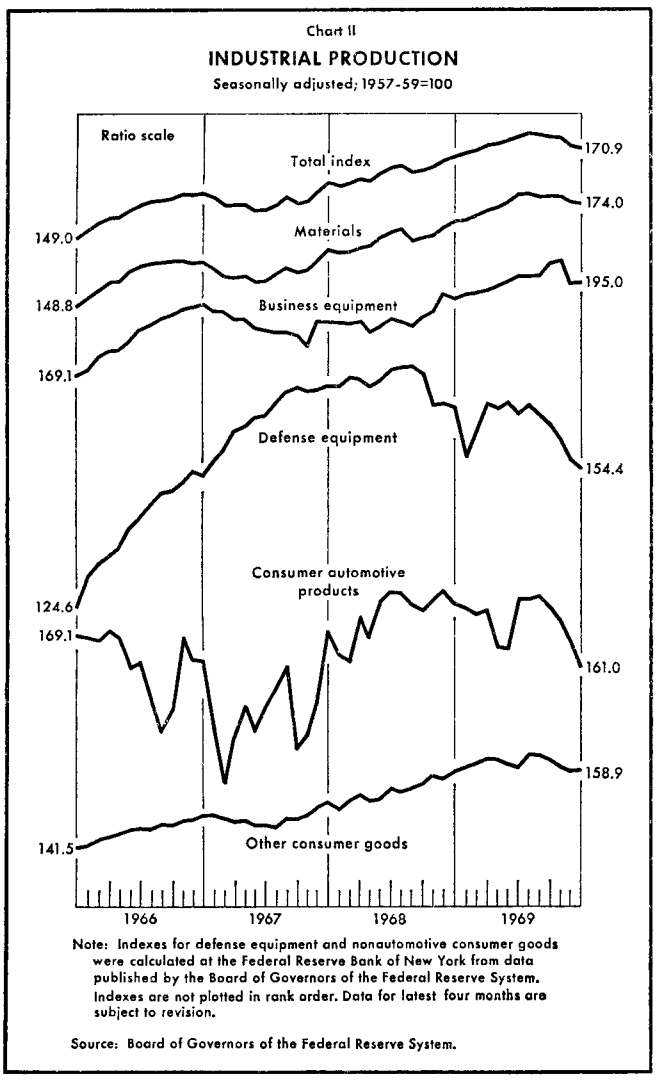
Although Government spending has continued to rise, the increases have tended to lessen. In total, Federal, state, and local government spending edged up $1.9 billion in the fourth quarter, down substantially from the relatively moderate $4.1 billion rise during the July-September period. National defense spending in the fourth quarter actually fell to a level below that of a year ago. While the growth rate of state and local expenditures was up a bit from the third quarter, the fourth-quarter rate is still considerably below rates registered in the first half. Statutory limitations on interest rates that state and local governments may pay on bonds have impeded financing of expansion in this time of tight credit.

INDUSTRIAL PRODUCTION AND ORDERS

Recent industrial production and new orders data indicate gradual slackening over the months of the fourth quarter. The Federal Reserve Board's index of industrial production fell 0.3 percent in December to 170.9 per-

cent of its 1957-59 level (see Chart II). While the current five-month decline has been the longest continuous monthly downswing in the index since the 1960 recession, the total magnitude of the decline from the July peak has been only 2.1 percent, somewhat less than from December 1966 to May 1967. Furthermore, about one third of the total fall is directly attributable to the General Electric strike, which began in late October.

Reduced auto production has been responsible for about one fourth of the decline in the total production index and is a major reason for the 3.2 percent fall in the output of consumer goods since July. Strikes at General Motors and American Motors plants held auto output down in September-October. In both November and December, Chrysler and General Motors shut down various plants several days in an effort to cut excessive inventories. In the month of December, assemblies declined a full 8 percent from an annual rate of 7.9 million units to 7.2 million units. The latest information indicates still further cuts in auto production. In January, auto assemblies fell to 6.5 million units (annual rate) as the Ford Motor Company joined the other two major auto producers in reducing output; moreover, the big three auto producers have announced additional layoffs for February. The production of other consumer goods, which began to decline before the onset of the GE strike, was 2.4 percent below the July level at the year-end.



Other categories of output have also fallen. Business equipment production had been quite strong until November, the first full month of the GE strike, when it plunged 3.3 percent. In December, there was only a slight recovery. Decreases in defense equipment output, however, have totaled 9.2 percent since July, and account for about 10 percent of the July-December decline in the total industrial production index. After a large drop in November, materials production edged down in December, with both the iron and steel component and the other materials component reaching levels about 1.4 percent below July. Moreover, ingot production, which is about half of the iron and steel component, declined 6 percent in January.

Another indication of slowing is that new orders received by manufacturers of durable goods have dropped. The orders series fell 4 percent in December to a level that is 8 percent below the September peak. This was the third consecutive month of decline. The December fall was entirely in the transportation equipment category, reflecting slower spending on autos and national defense.

EMPLOYMENT AND PERSONAL INCOME

The aggregate unemployment rate and other labor market indicators have suggested an easing of labor market conditions. The January unemployment rate of 3.9 percent was somewhat above the revised fourth-quarter average rate of 3.6 percent and showed an increase of joblessness in most age-sex categories. Other labor market indicators have shown reduced tightness over the fourth quarter, and January data suggest further moderation. The insured unemployment rate (the percentage of covered individuals receiving unemployment insurance benefits) was up significantly in November and December. Nonagricultural payroll employment has failed to grow from November through January. Furthermore, the average factory workweek in the last quarter of 1969 was down a bit, and in January there was a particularly sizable drop: the average workweek for factory workers in January fell from 40.6 hours

to 40.2 hours, while average overtime declined from 3.5 hours to 3.2 hours, the lowest level since mid-1967.

These factors, together with the GE strike, account for much of the reduction in the growth of personal income. Personal income increased by a modest $2.3 billion in December, bringing the average annual rate of growth during the fourth quarter of 1969 to 4.7 percent, down substantially from the annual rates of 7.8 percent in the third quarter and 8.4 percent in the first half. The more modest increases in personal income reflected a reduction in the growth rate of wage and salary disbursements, from 9.0 percent (annual rate) in the third quarter to 5.6 percent in the last three months of the year.

PRICE AND WAGE DEVELOPMENTS

Despite the current slowing of economic activity, there has been no apparent effect as yet on the rate of inflation. Wholesale industrial prices advanced at an annual rate of 4.2 percent in January, as prices of metals and metal products rose sharply. The January increase, about the same as that in December, was in line with the average price rise during the last half of 1969.

Recent increases in consumer prices belie earlier indications of slowing in the rate of inflation. It now appears that the third-quarter rate of 5.3 percent was not indicative of a downward trend in price increases: in December, consumer prices rose at a 7.4 percent annual rate, bringing the fourth-quarter annual rate of advance to 6.2 percent which is just about the same as the average rate during the first half of 1969. Overall, consumer prices rose 6.1 percent in 1969, compared with 4.7 percent in 1968. In fact, the rise from December 1968 to 1969 was the greatest twelve-month increase since the November 1950-November 1951 Korean war period. The huge December jump reflected a sharp rise in food prices, particularly those of fresh vegetables and eggs, and a large increase in the prices of consumer services.

Wage increases have also been large and well in excess of productivity gains. The rapid rise of labor compensation accompanied by lagging productivity resulted in substantial increases in unit labor costs in the private sector during 1969. The rise was almost 7 percent, compared with 5 percent in 1968, mainly because of much smaller productivity increases. Man-hour productivity recovered somewhat over the year, however, and the annual rate of increase of unit labor cost declined from 7.3 percent in the first quarter to 6.0 percent in the fourth quarter.

Furthermore, provisions of 1969 labor contracts covering 1,000 or more workers suggest that wages will rise rapidly over the near term as well. The median per annum wage and fringe benefit increase negotiated in 1969 major labor contracts was 7.4 percent, a substantial acceleration from the 6.0 percent per year median negotiated in 1968 contracts. Moreover, most of the contracts were front loaded—as has been typical in recent years—and provide in the first year of the contract for an 8.2 percent increase in wages alone; in 1968 the median advance in wages during the first year of the contract was 7.2 percent.

The Business Situation

The pace of economic activity continued to moderate as the new year began. In January, industrial production declined for the sixth month in a row, and the volume of new orders for durable goods fell for the fourth consecutive month. Activity in the construction sector—where output fell steadily throughout 1969—continued depressed, as housing starts and permits fell further. Conditions in the labor markets eased, with the unemployment rate rising to 4.2 percent in February. Reflecting the recent lack of growth in nonagricultural employment, personal incomes rose in January by the smallest amount in almost two years. Although signs of a slackening from the earlier hectic pace of business activity are widespread, the rate of price increases remains clearly excessive. At the consumer level, prices rose sharply in both December and January on a seasonally adjusted basis. At the wholesale level, the uptrend through January in prices of industrial commodities has been steep. The February rise in industrial wholesale prices was relatively small, but one month's reading of this series does not provide a basis for drawing significant conclusions.

The continued decline of several monthly indicators in January, following the small drop in real gross national product (GNP) in the fourth quarter of 1969, has raised some discussion of the possibility that we may be in a period of "recession". The decline currently indicated for the fourth quarter of last year, however, was very small and would probably not have occurred in the absence of strikes. Moreover, given the small size of the reported decrease, its reality will remain a question until the Commerce Department's annual revision of the GNP data later on this year.

The danger is that the current period of slowdown, whatever language is ultimately used to describe it, may prove too brief to make a serious dent in the inflation problem. It would be most unfortunate if a renewal of excessive demand were to add further to inflationary pressures.

PRODUCTION

The volume of industrial output declined again in January, with the continuing slump in automobile production an important factor in the drop. The Federal Reserve Board's index of industrial production fell 1.2 percentage points to 169.9 percent of the 1957-59 average (see Chart I). This latest drop brought the index to a level 2.7 percent below the peak reached last July. The strike at General Electric, which began late in October and con-

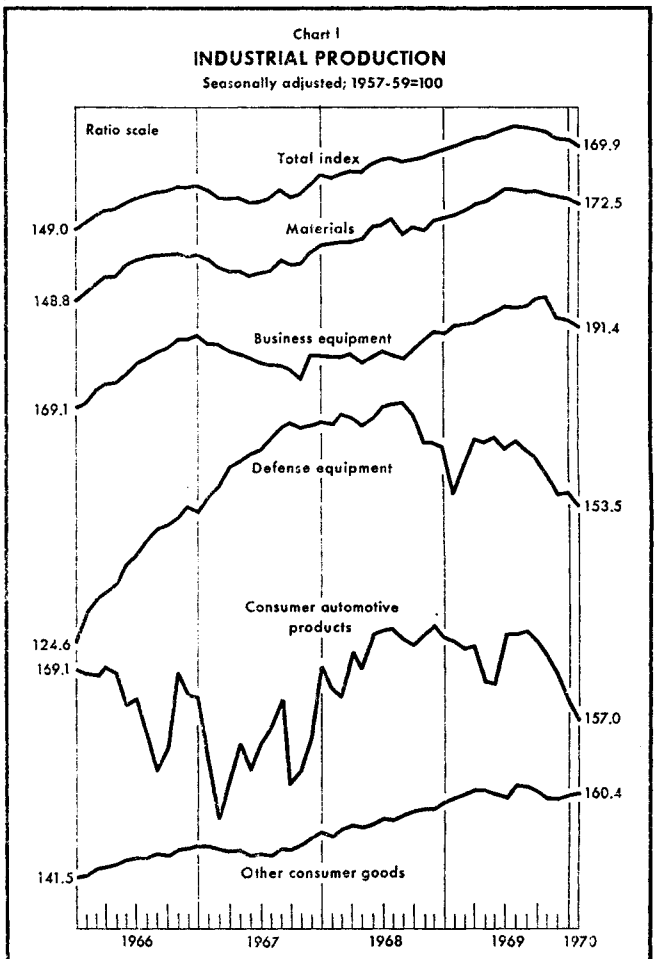
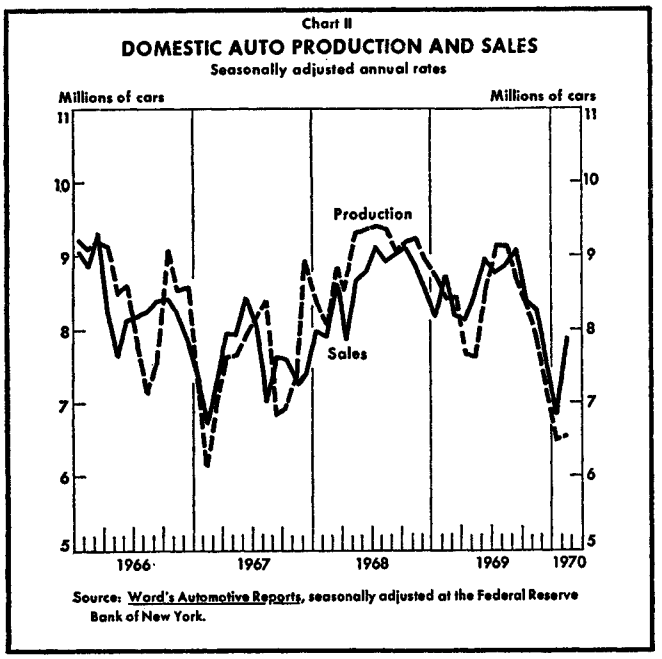


Chart I
INDUSTRIAL PRODUCTION
Seasonally adjusted; 1957-59=100

Note: Indexes for defense equipment and nonautomotive consumer goods were calculated at the Federal Reserve Bank of New York from data published by the Board of Governors of the Federal Reserve System. Indexes are not plotted in rank order. Data for latest four months are subject to revision.

Source: Board of Governors of the Federal Reserve System.



tinued through early February, contributed to the slump. Excluding the effects of this strike, the overall decline has been about 2 percent. Last month's settlement of the GE strike will tend to shore up the February production index, particularly equipment output. The equipment index dropped rather sharply after the strike began, and December and January saw further small declines.

A good part of the recent slowdown in the industrial sector has resulted from developments in automobile sales and production. The final quarter of 1969 was marked by a substantial weakening in sales of domestically produced automobiles (see Chart II), although sales for the calendar year as a whole totaled 8.5 million units. The beginning of the new year saw a somewhat mixed pattern: in January, sales fell by over 10 percent to a seasonally adjusted annual rate of 6¾ million units; in February sales jumped to an 8 million unit rate, although a considerable part of this rise may reflect an unusually large number of sales contests as well as General Motors' introduction of new models. The drop in sales has led to a substantial increase in dealers' stocks. As in the past, auto producers reacted quickly to the change in demand and reduced production schedules. After averaging yearly production rates of 8¾ million units (seasonally adjusted) in the August-October period, production fell to an average of 7½ million units in the final two months of last year and then dropped to a 6¾ million unit rate in January and February, according to revised data. Indeed, the decline of the motor vehicles and parts component by itself has accounted for about a quarter of the total July-January decrease in the industrial production index, and has also created layoffs in that and other related industries.

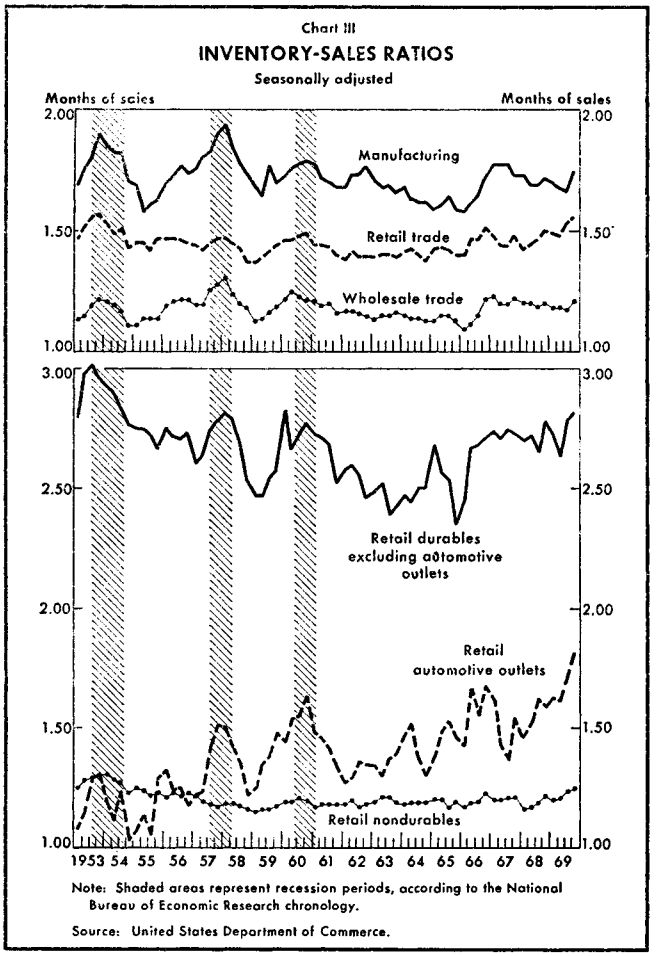
While the index for automotive products was cut back substantially in January, output of most other consumer goods was about unchanged. There has been some weakening in production of consumer goods exclusive of automotive products since the July peak, but the decrease has not been large. Partly reflecting reduced demands from auto makers, iron and steel production fell 4.6 percent in January. Steel ingot production, which accounts for about half of the overall iron and steel component of the industrial production index, edged down further in February.

ORDERS, SHIPMENTS, AND INVENTORIES

The recent behavior of new orders for durable goods increases the prospects for a continuation of the current weakness in industrial production. The volume of durables orders fell by 5.2 percent in January, the fourth consecutive month of decline. This latest drop pushed the volume down to $28.7 billion, 11 percent below the record reached last September. The January fall was broadly based, as orders for automobiles, aircraft, fabricated metals, construction materials, and machinery all dropped.

The January data on manufacturers' inventories and shipments suggest further involuntary inventory accumulation among durables manufacturers. For durables industries, the inventory-sales ratio has increased steadily since last October, while the nondurables ratio has fallen to record lows. By December, it had become apparent that some imbalance between inventories and sales was developing in the trade sector as well as in manufacturing (see Chart III). In that month, total business sales dropped by $1 billion and total business stocks increased by that amount.[1] Thus the inventory-sales ratio for all business rose sharply, reaching the highest level since early

[1] The Department of Commerce has revised downward its gross national product estimate of business inventory accumulation to an annual rate of $7.7 billion from the preliminary figure of $7.8 billion discussed in the February issue of this *Review*. Consumption spending was revised upward, while the estimates for business fixed investment and government spending were reduced. The estimate of total fourth-quarter GNP was revised downward by $0.9 billion to a seasonally adjusted annual rate of $952.2 billion, and real GNP was revised down by $0.7 billion to $729.8 billion, $0.8 billion below the third-quarter rate.



Note: Shaded areas represent recession periods, according to the National Bureau of Economic Research chronology.

Source: United States Department of Commerce.

1967. In contrast to the experience in 1967, when much of the rise in the inventory-sales ratios resulted from an actual step-up in the pace of inventory accumulation, the recent rise in the ratios stems chiefly from a decline in sales. The major inventory-sales problem appeared to be in the retail sector, where the ratio was the highest since 1954. While an increase in retail auto inventories was a factor in this rise, a steep run-up in the inventory-sales ratio also occurred among other durables stores and at nondurables outlets. These increases occurred at a time when high interest rates presumably would have encouraged low inventory levels.

RESIDENTIAL CONSTRUCTION

The downtrend in residential construction activity has been much steeper than the decline in the industrial sector, and the near-term outlook remains weak. Throughout 1969 the number of new private housing starts declined, although for the year as a whole starts totaled 1,463,000 units—slightly above the levels averaged in the last eight years. In January the downward movement continued, as the volume of starts fell by almost 100,000 to a seasonally adjusted annual rate of 1,166,000 units, the lowest since early 1967. Recent behavior of the series on building permits also points to continued weakness in residential construction. The volume of permits issued by local authorities headed down for most of last year, and in January of this year permits dropped by a precipitous 25 percent to a level 20 percent below the 1957-59 average and about 40 percent below the 1969 rate.

Data on housing starts and permits relate to housing units built on site—that is, these data measure output in the residential construction sector and do not include mobile home production. If mobile home output is added to the public and private starts figure, the volume of new housing units produced in 1969 actually surpassed 1968 output. While mobile homes are not necessarily close substitutes for conventional housing, an increasing number of persons apparently regard them as an attractive alternative, particularly in light of current housing market conditions. Last year, mobile home sales reached 400,000 units, almost half of all new single-family housing units purchased. Moreover, these sales accounted for 90 percent of those new units which sold for under $15,000.

PLANT AND EQUIPMENT SPENDING

In sharp contrast to the slowing in most sectors of the economy, the demand for capital investment was firm through the end of 1969, and it is possible that this strength will continue this year. The results of private surveys, taken in February, of business spending plans for plant and equipment were in line with the trend seen in both Government and private surveys taken in the latter half of last year. As 1969 drew to a close, successive surveys tended to report increasingly higher advances in capital investment plans for 1970. The size of the planned rise reported in these surveys varied between 5 percent and 9½ percent, with the latter increase reported by the special survey taken by the Department of Commerce and the Securities and Exchange Commission in December. These late-1969 surveys were taken before the slackening in economic activity became very marked, and it has been widely thought that subsequent surveys would indicate a downward revision in business spending plans. The private February surveys did point to a cutback by automotive companies, but total outlays by manufacturers are scheduled to rise by more than had been anticipated last fall. The fourth-quarter

1969 decline in manufacturers' net new capital appropriations suggests that the increase in manufacturing outlays may be confined to the first half of 1970. The private surveys taken in February forecast a 10 to 14 percent rise in total plant and equipment expenditures in 1970. While the results of these surveys are consistent with the trend shown in those taken last year, their findings must be viewed with caution. Tight credit conditions, the profit squeeze, the low level of corporate liquidity, and the weaker sales outlook are all major factors dampening the prospects for capital spending this year.

CONSUMER DEMAND, EMPLOYMENT, AND PERSONAL INCOME

Much of the current slowing in economic activity has stemmed from the continued sluggishness of retail sales. For most of 1969 the sales pace was lackluster: total sales for the year were up only 3½ percent from 1968, compared with an 8¼ percent advance the year before. The increase in sales was substantially less than the 5½ percent rate averaged by the consumer price index. In the last several months, retail sales have declined steadily and the weakness has been broad based, though the slump in auto sales has been a major factor. In January, according to the preliminary estimate, sales fell a further 1 percent to $29.1 billion—a level $0.5 billion below the October peak.

Part of the recent weakness in retail sales can be attributed to the slowdown in personal income growth. In January, the increase in incomes was the smallest in almost two years. Wage and salary disbursements rose by only $1.2 billion to a seasonally adjusted annual rate of $529.0 billion. Since October the monthly gains in wage and salary disbursements have averaged $2.3 billion, compared with an average of $3.6 billion in the first ten months of last year.

The lower rate of advance in personal income has largely reflected the recent easing in labor market conditions. Payroll employment surveys indicate that between October and February nonfarm employment rose by only 100,000, compared with an advance of 1¾ million in the first ten months of last year. The employment survey conducted among households also points to an easing of labor market pressures. The unemployment rate, which had averaged 3.4 percent in the first eight months of last year, rose in the September-December period to an average of 3.7 percent. The rate jumped to 3.9 percent in January, as a large increase in the labor force outweighed a gain in employment. In February, nonagricultural employment fell back to the December level and the number of unemployed rose, pushing the unemployment rate to 4.2 percent.

RECENT PRICE DEVELOPMENTS

Despite the clearly evident slowing of the economy in the last few months, the excessive rate of price increases has thus far continued unabated. In January the seasonally adjusted consumer price index rose at a 7.2 percent annual rate for the third month in a row.[2] Leading the January advance was a jump in the transportation index, which reflected increases in automobile insurance and repairs as well as the 50 percent hike in the New York City transit fare. Higher food prices—particularly for meat and eggs—were a major factor in the latest rise. On a December-to-December basis, food prices last year climbed by 7.2 percent, while the total index rose by 6.1 percent.

At wholesale, prices of both industrial goods and farm and food products rose sharply in January, pushing the total wholesale price index up by 0.8 percent. Increases in the cost of both ferrous and nonferrous metals were major factors in the advance in industrial prices. The preliminary estimate for February indicates only a small rise in prices for both industrial and agricultural commodities, following January's surge.

[2] The Bureau of Labor Statistics is now incorporating a seasonal adjustment factor into its series on consumer prices. While some of the components of the index—such as food—have substantial seasonal variations, for most months these changes are about offsetting. Thus, the seasonal pattern for the total index is small.

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The Business Situation

The most recent business news has continued to indicate some further current slowing in the economy. Industrial production drifted down in February for the seventh consecutive month, despite settlement of a major strike. While new orders received by durables manufacturers moved higher, the orders inflow was still substantially below the September peak. Although housing starts advanced, the near-term outlook for home building remains unfavorable. The unemployment rate rose to 4.2 percent, weekly working hours were shortened, and personal income registered only a modest gain. Despite the easing in demand pressures, prices continued to advance at a rapid pace. While March wholesale price data suggest the possibility that the rate of price advance may be starting to moderate, the evidence for any such turn of events is still very scanty. Recent sizable wage settlements and the prospect of further large contract agreements this year indicate that labor cost pressures will remain intense.

The slowdown in economic activity has been concentrated in certain particular sectors, most notably home building and automobiles. There is a possibility that the decline in automobile sales and production may be bottoming out. At the same time, recent surveys of capital spending intentions give no indication that plans for sizable 1970 increases have been cut back. The boost in social security payments in April, retroactive to the beginning of the year, and the phasing-out of the surtax are adding to spendable income. In addition, it would now appear that Federal Government employee pay increases cannot be postponed until 1971 and that the increases granted may be larger than foreseen when the budget was prepared.

PRODUCTION, INVENTORIES, AND SALES

The industrial production index drifted downward for the seventh consecutive month in February. The total drop has been 3.0 percent, a little greater than the 2.4 percent decline during the months of the 1967 mini-recession. On the other hand, the recent 3.0 percent drop is sharply below the 7.3 percent contraction recorded for the mildest post-World War II recession, which occurred at the outset of the 1960's. The February drop in the index of 0.5 percent exceeded only by a small margin the average monthly decline between last July and this January. If, however, allowance were made for the resumption of work at General Electric early in February, the total production index would have dropped close to 1.0 percent for the month.

The February production decrease reflected a sizable reduction in the output of nondurables manufacturers, a sector that had held up well in the last half of 1969. February declines in this sector were widely shared by the textiles and apparel, paper, chemicals, petroleum, and rubber industries. The output of durables manufacturing, the sector accounting for the bulk of the seven-month drop in the overall production index, decreased again in February, with substantial further slippages in iron and steel output and the production of motor vehicles and parts. Ingot production figures for March, however, suggest a slight recovery in iron and steel production. The motor vehicles and parts component has accounted for approximately one quarter of the July-February drop in the overall index. Auto assemblies have fallen dramatically from a seasonally adjusted annual rate of 9.1 million units last summer to a 6.5 million unit rate in February. Higher output in March, running at a 7.0 million unit pace, and production schedules for the April-June period suggest that a bottoming out has occurred, although schedules may be cut back further if sales fall short of expectations. In contrast to manufacturing, considerable strength is still apparent in the mining and utilities components of the production index.

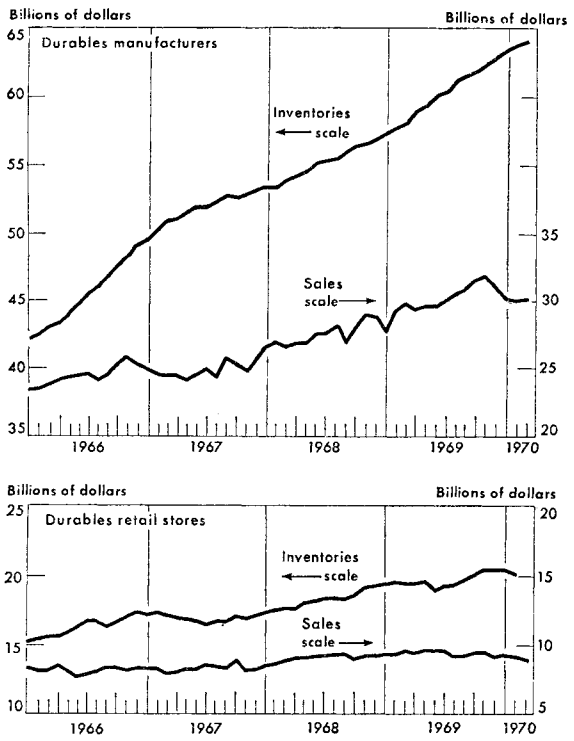
Despite the decline in industrial production, there had been a continuing modest accumulation of inventories until January, when the first outright decrease since June

1967 occurred. Falling sales, however, have largely accounted for the increase to a very high level in the ratio of stocks to business sales. Even for January, when businesses in certain sectors had some success in correcting inventory imbalances, the overall ratio remained high. The imbalances have been centered in the positions of durables retailers and durables manufacturers, for which decreasing sales have been marked (see Chart I).

Durables retailers' inventories declined in January, but by proportionately less than sales, so that the ratio of stocks to sales continued to rise. While the ratio has been high for many sectors, autos dominate the statistics. Inventories of automotive retailers were reduced each month from October to January, even though sales dropped sharply. Although the ratio of stocks to sales thus rose through January, recent unit sales and production figures point to success in industry efforts to improve the alignment of the stock of unsold cars and the pace of sales.

Chart I

INVENTORIES AND SALES OF DURABLE GOODS



Source: United States Department of Commerce.

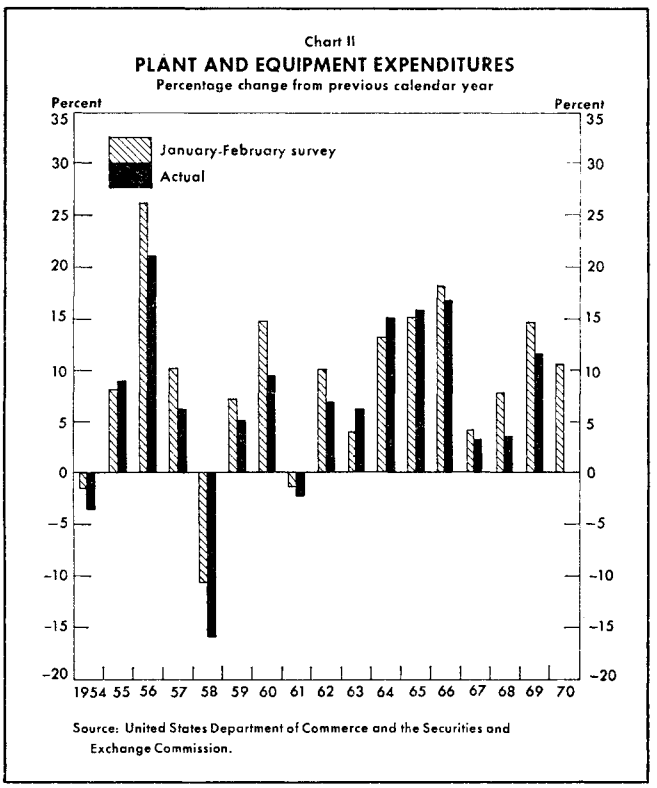
Unit sales of domestic-model cars registered a pronounced advance in February to a seasonally adjusted annual rate of nearly 8 million units; this advance was partly attributable to new-model introductions and sales contests. As a result, the stock of unsold cars, on a seasonally adjusted basis, dropped to the lowest level since last July. In March, the sales pace slipped back to close to 7½ million units but remained considerably above the January rate of less than 7 million units.

The inventory buildup of durables manufacturers was modest in both January and February. Although shipments rose in February for the first time since last October, the improvement in the balance between inventory holdings and sales was slight. Except for January, the inventory-sales ratio in February was the highest since October 1967. The sharp advance in the ratio to the high level at the outset of 1970 reflects a softening in sales rather than unusually large inventory gains. Half the drop in durables shipments since the October peak resulted from weakening sales of auto manufacturers; the remainder reflected lower shipments of electrical machinery and equipment, instruments, and aircraft. This pattern suggests that the work stoppage at General Electric and the declining demands for autos and defense-related products were largely responsible for the drop in sales.

The inflow of new orders to durables producers rose in February, and the January figure was revised upward; nonetheless, new bookings remained considerably below the peak recorded last September. The principal source of strength was new orders for aircraft. Orders received by machinery and equipment industries continue to reflect the strength in capital spending.

CAPITAL SPENDING AND RESIDENTIAL CONSTRUCTION

Businessmen plan to continue to increase their spending for expansion and modernization of production facilities at a rapid pace, according to a recent survey conducted by the Commerce Department and the Securities and Exchange Commission. The findings of the survey, taken in late January and in February, indicate that expenditures on plant and equipment will advance 10.6 percent in 1970 from the 1969 level, which was 11.5 percent above that for 1968 (see Chart II). Last year's increase in capital spending fell short of the 14.7 percent gain that the survey conducted in early 1969 had indicated. This suggests that some postponements, delays, or cancellations affected 1969 spending. Since late last summer, businessmen have raised their capital spending intentions for 1970 from around 5 percent above last year's



level to the latest Commerce-SEC estimate of 10.6 percent. In addition, the latest survey results show that capital spending will accelerate during the second half of this year following a period of modest growth. The fall in 1969 estimates and the rise in those for 1970 suggest a shift to 1970 of spending originally planned for late last year. There is a possibility that further stretch-outs may be in the offing; when economic activity slows, businessmen's early estimates often overshoot actual spending. Nonetheless, the January-February Commerce-SEC survey results have generally proven fairly accurate in estimating the year-to-year changes in plant and equipment expenditures.

The January-February survey shows substantial further increases in capital spending for 1970 by the electrical and nonelectrical machinery, railroad, electric utility, and communications industries, where demands for products and services have remained relatively firm. On the other hand, weak demands in several industries have apparently led to planned reductions in capital spending; cutbacks are expected by the steel, motor vehicle, aircraft, and rubber industries. Possibly in response to steeply rising prices, capital spending plans point to greater efforts by food processors and the nonferrous metals industries to expand or modernize their production facilities.

While capital spending has been a buoyant factor in the economy, spending on residential construction has been in a steep downtrend since April 1969, and housing starts have fallen through January 1970. Although starts recovered in February, jumping 10.4 percent, it is doubtful that this upsurge represents a real turnaround in the housing sector. Unusually severe weather conditions in January could have cut deeply into starts that month, with postponements reducing the January figure and lifting the February rate; the January-February average at a seasonally adjusted annual rate of 1.26 million units was lower than the rate for any other two-month period since the spring of 1967.

EMPLOYMENT AND PRICES

The unemployment rate moved to 4.2 percent in February from the previous month's 3.9 percent. Although still low by historical standards, the unemployment rate was nearly 1 percentage point above that recorded a year before. The jobless rates for most labor force groups are appreciably higher than in early 1969, but much of the increase in unemployment has occurred for adult males. Since men normally remain in the labor force when they become unemployed, rising unemployment has not appreciably diminished strong growth in the civilian labor force, and the overall unemployment rate has rather fully reflected the easing in the demand for labor. While this demand has weakened more in the areas where a dominant proportion of those employed are men, the sizable reduction in the number serving in the armed forces—202,000 persons from September 1969 to February 1970—has also contributed to the larger increase in unemployment among adult males. By occupational groups, the unemployment rate for blue-collar workers has increased more than those for white-collar workers and service workers; by industry classes, the rates for manufacturing and construction have advanced more than those for trade, finance and services, and government.

The easing in demand for labor may also be seen in shortened workweeks. Most of the reduction in hours has occurred in manufacturing, where the seasonally adjusted workweek dropped below forty hours in February for the first time since January 1962. The average workweek has declined a full hour since March 1969, and average overtime hours have fallen markedly. Even though premium-pay overtime hours have been reduced, labor costs per unit of output continue to soar. While cost pressures are expected to remain very strong, the passing of these costs on to buyers in the form of higher prices becomes more difficult as demand pressures ease. As yet, however, these forces

have had a minimal impact on inflation.

At the wholesale level, industrial commodities prices continued rising at close to a 4 percent annual rate in February, about the same as the average monthly increase recorded last year. In March the upward pace slowed to about 3 percent mainly because of a much smaller rise in iron and steel prices. With the notable exception of the lumber and wood products component, which continued on a downtrend, most other major industrial commodities classes showed rising prices. Agricultural commodities prices edged up in March after increasing sharply for three months. Thus, price boosts are still widespread and, given the often erratic movements in these price indexes, it is too soon to draw a firm conclusion regarding the trend in wholesale prices.

The consumer price index continued its excessive climb in February, advancing at an annual rate of 6.4 percent, compared with last year's average rate of 6.1 percent. Both services prices and food costs are still rising at extremely high rates, nearly 9 percent and 7 percent, respectively. Nonfood commodities prices registered a fairly small increase, however, rising at a 3 percent rate as compared with 4½ percent through 1969 largely because of further declines in the prices of new and used cars. Sizable increases in the costs of medical care, apparel prices, and mortgage interest charges contributed heavily to the overall gain.

The Money and Bond Markets in March

Conditions in the money market were somewhat more comfortable during March than in the previous month. Federal funds traded chiefly in a range of 7 to 8½ percent, while they had traded around 9 percent through much of February. Member bank borrowings from the Federal Reserve Banks also eased back. In the Treasury bill market, rates on new issues dropped sharply to the lowest levels in almost a year before rising again toward the close of the month.

There was a noteworthy quickening in the growth of monetary and credit aggregates during the month (see Chart I). Both the money supply and the adjusted bank credit proxy expanded in March. From December through March the money supply grew at a 3.2 percent seasonally adjusted annual rate, compared with a 0.6 percent rate in the last half of 1969. The adjusted bank credit proxy also exhibited some modest growth for the quarter as a whole after having declined during the first two months.

In the capital markets the burgeoning calendar of corporate bonds for March and April gradually dissipated the optimism built up in February. A sharp rise in new issue yields and a disappointing investor response generated a gloomy atmosphere that spread to the markets for Treasury coupon securities, Federal agency issues, and eventually municipal bonds. The gathering gloom quickly gave way to ebullience on March 18, however, when Chairman Burns' testimony before a Congressional committee was taken as confirmation that some relaxation of monetary policy was under way. The subsequent rally extended to most segments of the capital markets over the next few days, and further impetus was provided on March 25 when a number of money center banks reduced their lending rates to prime borrowers by ½ percentage point to 8 percent.

BANK RESERVES AND THE MONEY MARKET

The effective rate on Federal funds averaged 7.7 percent during March, compared with an 8.9 percent level a month earlier. Average borrowings at the discount window declined to $880 million (see Table I) from $1.1 billion in February, and net borrowed reserves were also lower. Among short-dated money market instruments the bid rate on ninety-day bankers' acceptances fell ¾ percentage point to 7½ percent, while rates on directly

The Business Situation

The slowdown in economic activity in the first quarter of 1970 was reflected in both a decline in real GNP and an increase in unemployment. At the same time, price and cost pressures continued to be severe. Toward the end of the quarter, there were some tentative signs of a bottoming-out in economic activity and of a slight moderation in price pressures. Industrial production increased in March for the first time since last July, and housing starts posted a second successive monthly gain. At the same time, price increases at the wholesale level showed some signs of lessening in March and April.

More broadly, the economic outlook remains quite strong despite a number of uncertainties, including the recent sharp drop in the stock market and developments in Indochina. In April the pay increase for Federal employees and the boost in social security payments began to add to spendable income, and the income tax surcharge is due to expire at the end of June. Moreover, recent surveys continue to suggest that a sizable growth in capital spending is likely. The underlying strength of the economy and the prospect of continued large wage settlements point to the need for persistence in the fight against inflation.

GROSS NATIONAL PRODUCT

The nation's total output of goods and services, according to preliminary estimates, declined again in the first quarter of 1970, after allowing for the continued sharp increase in prices. Real gross national product (GNP) fell at an annual rate of 1.6 percent, following the previous quarter's fractional decline. Despite this further slowing in real GNP, the implicit price deflator accelerated slightly from a 4.7 percent rate of growth in the final quarter of last year to the first quarter's rate of 5.0 percent. While this information scarcely constitutes evidence that inflation has worsened, it does cast doubt on the view that prices are beginning to respond favorably to moderating demand. Expressed in current prices, GNP continued to expand, but the gain of $8.2 billion (see Chart I) was the smallest since the first quarter of 1967. As in the fourth quarter of last year, the expansion in current-dollar GNP was depressed by a sharp drop in inventory accumulation. Final demand, that is, GNP less inventory change, actually rose by a slightly larger amount in the first quarter than in the October-December period. The first-quarter increase in final demand was centered in consumer spending for nondurable goods, in business fixed investment, and in state and local government purchases.

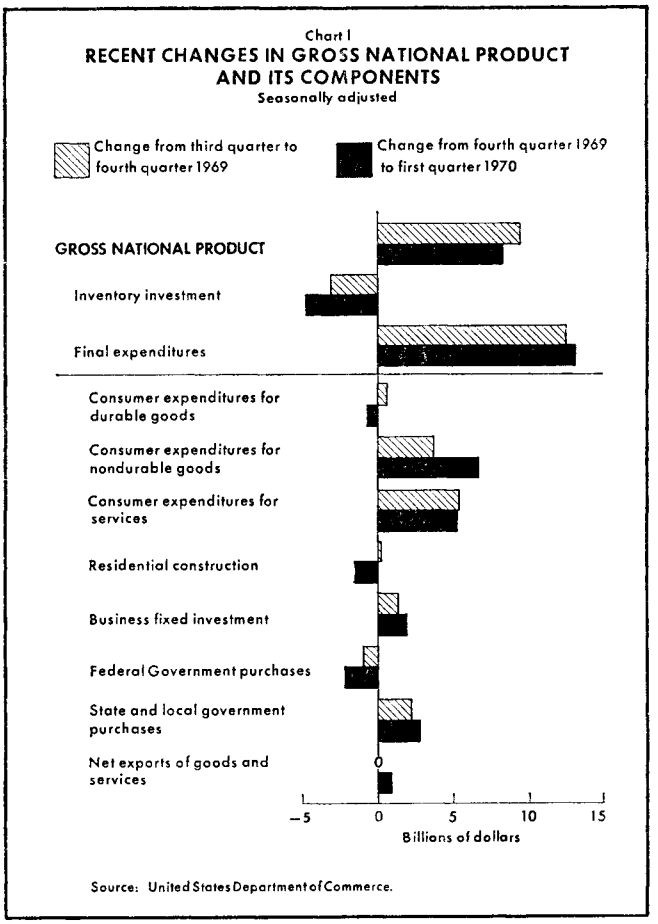
The inventory component exerted a $4.8 billion drag on the expansion of GNP. A slowdown in inventory spending can reflect either deliberate efforts to correct for excesses in stocks or an unexpected bulge in sales. In the first quarter, the former appears to be a more plausible explanation for most of the behavior of inventories. The business inventory data for January and February, on which these preliminary inventory estimates are based, indicate that firms in the durable goods sector at both the manufacturing and trade levels have attempted to correct the imbalances that developed near the end of 1969. This behavior has been particularly evident in the automobile industry, where the stock of unsold cars has been reduced substantially since late last year. On the other hand, consumer spending on nondurable goods showed such strength that some of the slowdown in inventory accumulation may have reflected unexpectedly strong sales.

The reduction of the income tax surcharge from 10 percent to 5 percent at the beginning of 1970 contributed substantially to the first-quarter gain in disposable personal income. While the first-quarter rise in pretax income was only $0.2 billion more than that for the preceding quarter, spendable income rose by $3.9 billion more in the first quarter of 1970 than in the previous quarter. The first-quarter gain in disposable income was

accompanied by a fairly large increase in personal consumption expenditures, and the saving rate changed very little. The boost in consumer spending reflected the largest increase in expenditures on nondurable goods since the first quarter of 1968. Spending on services continued to expand at much the same rate as in recent quarters, but expenditures for durable goods declined slightly. Much of the weakness in durables can be seen in unit auto sales, which dropped from a seasonally adjusted annual rate of 8.1 million units in the final three months of 1969 to a 7.4 million unit pace in the first three months of this year. The poorest sales performance occurred in January, however, when dealer deliveries were at a 6.8 million unit rate. Auto sales recovered strongly in February to a 7.9 million unit rate, then fell back in March to a 7.4 million unit pace. In April the sales pace was a little better than the previous month's rate.

Investment in plant and equipment continues to expand, in agreement with the surveys of business capital spending intentions. Most of the first-quarter increment resulted from a fairly sizable rise in spending on structures. The unusually small increase in expenditures on equipment probably reflected the General Electric strike. Recent survey findings and actual spending results have yet to show the cutbacks that might normally be expected in light of falling profits, plant operating rates substantially below preferred levels, and tight credit conditions; apparently, efforts to check the steep climb in labor costs continue to outweigh such inhibiting factors. The McGraw-Hill spring survey indicated a 9 percent increase in 1970 expenditures on plant and equipment. Although this represents a slightly smaller gain than the Department of Commerce-Securities and Exchange Commission survey had indicated earlier in the year, the 9 percent boost exceeds, though narrowly, that which had been suggested by the fall McGraw-Hill survey. Upward revision of spending plans by nonmanufacturing firms has tended to offset some cancellations or deferrals by manufacturers.

Spending on residential structures declined in the initial quarter of 1970 and remained substantially below the high attained at the outset of 1969. Housing starts were also down for the quarter, but the rate moved up from the very low January figure with some vigor in the latter two months of the period. Despite the February and March advances in starts, the near-term outlook for home building appears considerably short of buoyant. The rate of starts is still substantially below the pace recorded in early 1969 and the rate of permits issued for new homes fell off in March, though this series has been unusually wobbly of late. The availability of funds for mortgages has shown some slight improvement in recent months,



but land, labor, and financing costs continue to soar, pushing the price of homes beyond the means of a growing proportion of young families.

The increase in state and local government spending was larger in the first quarter than in either of the preceding two quarters, although these governments continue to experience financing difficulties. Federal Government expenditures dropped by $2.1 billion in the first quarter, the largest decline since the spring of 1954; a cutback in defense outlays accounted for most of the fall. Upward pressures in expenditure programs continue to accumulate, however, and the Federal employees' pay increase, retroactive to December 27, will also contribute to higher Federal spending.

The remaining GNP component, net exports, added $1.0 billion to the expansion in total spending. In recent quarters, the growth in exports of goods and services has exceeded that for imports; first-quarter net exports were at the highest level since late in 1967.

INDUSTRIAL PRODUCTION

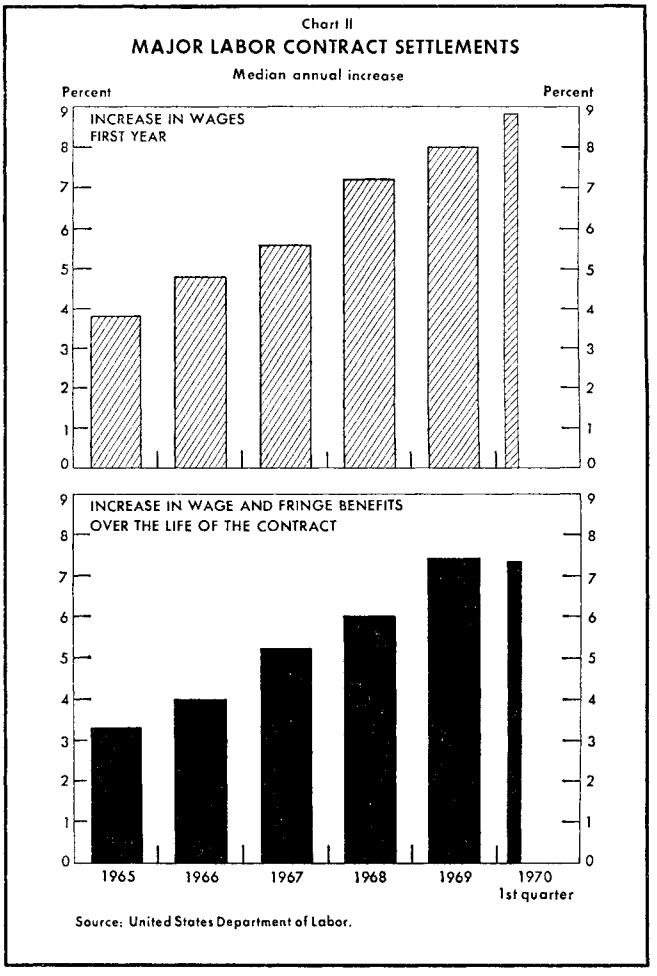
Like real GNP, industrial production was lower in the first quarter of this year than in the final quarter of 1969, but the monthly data on industrial output showed a slight rise in March following a small decline in February and a sizable drop in January. This pattern raises the possibility that production, after a seven-month downward drift in the overall index, may be regaining some strength. The decline in output from last July to this February was gradual, and never developed into the widespread, sharp cutbacks in production that have been associated with post-World War II recessions. The total decline in the July-February period was 2.7 percent, exceeding narrowly the 2.4 percent drop in the index that had occurred during the mini-recession of early 1967. Subsequent to similar extended periods of decline, a one-month rise has usually been followed shortly by an upswing. The March figures, however, are still preliminary, and past experience, of course, need not be repeated.

Although the resumption of operations at General Electric plants, following a long strike, contributed positively to the production index in March as well as in February, the March rise in the index reflected mainly sizable gains in the automotive products and steel components, two industries that are highly sensitive to cyclical fluctuations in demand. Iron and steel production rose 2.4 percent in March, the largest gain since last June, and the raw steel output figures suggest another increase in April. As long as the export demand for steel products remains healthy, as is expected, the near-term outlook for the industry is primarily dependent upon the auto situation.

The output of motor vehicles and parts advanced by 5.6 percent in March, the first increase since last July. The same pattern is evident in the unit figures, as auto production fell from a seasonally adjusted annual rate of 9.1 million units last July to a 6.5 million unit pace in February, then rose to a rate of 7.1 million units in March. As sales have shown some steadiness, inventories have been brought down further in recent months. The stock of unsold cars at 1.4 million units was at the lowest level, on a seasonally adjusted basis, for any month since the summer of 1968 with the exception of July 1969, when dealer inventory holdings were at about the same level. With inventories coming within acceptable limits and the demand for new autos at least holding firmly at recent levels, production schedules for the April-June period indicate that output might continue rising. Nonetheless, actual production in April ran below the planned rate, apparently reflecting plant shutdowns necessitated by striking teamster locals rather than an unexpectedly poor sales performance. In the months immediately ahead, the production figures will no doubt show adjustments in anticipation of a possible strike by auto workers when the contract expires in September.

WAGE AND PRICE DEVELOPMENTS

The slowdown in economic activity has been accompanied by easing in the demand for labor, but labor costs continue to rise steeply, and recent labor contract settlements indicate that these costs will remain a source of intense pressure on prices in coming months. Summary data on major collective bargaining settlements for the 1965-69 period bring into sharp focus the uptrends in first-year wage increases and in the wage-benefit package over the life of the contract (see Chart II). Preliminary first-quarter data for 1970 indicate a further boost in the



first-year wage gain, while the overall wage-benefit increase remained about the same as last year's median. First-quarter agreements covered fewer than 700,000 workers of the approximately five million covered by contracts expiring this year. The relatively small number of workers receiving large first-year wage increases as well as declines in overtime work in some high-wage industries have thus far limited the impact of such settlements on labor compensation per man-hour in the private economy, but the increase has been rapid. Combining the trend in labor compensation with the poor performance of productivity, unit labor costs have been accelerating and rose at an annual rate of 8 percent in the first quarter, the largest advance for any quarter in fourteen years. Sizable first-year wage gains will tend to offset the effects of any improvement in productivity. In the contract negotiations this year, workers are seeking to maintain an increase in real wages and to catch up with other workers who have already obtained generous settlements. As economic activity slows, the easing of pressures in the labor market should tend to reduce the size of union and nonunion wage settlements, and the easing of demand pressures will make it more difficult for firms to pass along additional labor costs through higher prices. Nonetheless, we cannot expect slower economic activity to return the rate of wage increase in the near future to the noninflationary pace of long-term productivity.

Although industrial wholesale prices continue to rise at an excessive rate, there are some indications that the rate of increase may be slowing. According to preliminary data, which have been subject to upward revisions in recent months, industrial commodities prices rose at a 3.1 percent annual rate in April. The April gain was equal to that for March, but it was below the rates recorded in the first two months of the year and the average monthly increase registered last year. In addition, cyclically sensitive materials prices have tended to ease downward in recent months, possibly foreshadowing a further slowing in the industrial commodities component. Agricultural products prices fell in April, causing the overall wholesale price index to fall. The agricultural component often moves erratically, however, and the overall index may thus be of questionable value in discerning the trend in wholesale prices.

Consumer prices rose at a 6.3 percent annual rate in March. The March advance in the index exceeded, though narrowly, the average monthly gain of 6.1 percent recorded through 1969 and was noticeably higher than the 5.5 percent rate of increase registered for the first two months of this year. Reflecting sharp boosts in mortgage charges and medical care costs, the gain in services prices was extraordinarily large, and the cost of nonfood commodities climbed at the fastest pace since last November. On the other hand, a very small rise in food prices softened the advance in the overall index. After adjustment for seasonal variation, the consumer price index still shows no solid evidence of a slowdown in its rate of increase. Even though the adjusted figures indicate a rise of 4.8 percent for March, the rate of gain through the first three months of 1970 on this basis is essentially the same as the average monthly rate in 1969.

The Business Situation

Most recent business indicators have suggested some further easing of economic activity, but the depressing effects of several major strikes have made the numbers difficult to interpret. Strikes were a major factor in April declines in payroll employment, private wage and salary incomes, and industrial production. Housing starts also declined in April, but the decrease in this often volatile series followed unexpected rises in the two previous months. Moreover, residential building permits rose in April, raising the possibility that the longer term downtrend in housing may be approaching an end.

Despite the indications of further business declines in April and the sharp drop in stock prices—partly reversed after the May 26 low—there is no evidence that the slowdown in economic activity is intensifying. Industrial production, for example, has been about flat on balance in the first four months of 1970 in contrast to a distinct downtrend in the last half of 1969. As to the future, prospects for some resumption of real growth during the last half of the year still seem good. While the declines in stock prices may have some adverse effect on the outlook for consumer spending, personal incomes have received a powerful boost from higher social security payments and the Federal pay increase. The scheduled elimination of the remaining 5 percent tax surcharge will further add to disposable incomes beginning in July. Corporate profits declined sharply in the first quarter, and manufacturers have marked down their plant and equipment spending plans. Nonetheless, capital spending plans of manufacturing and nonmanufacturing firms as a whole are still scheduled to rise over the rest of the year. Spending by state and local governments will almost certainly be another plus item. The two major areas of weakness so far this year have been residential construction and inventory spending. Even a flattening-out in these sectors would represent an important contribution to revived real growth in the overall economy. In the meanwhile, inflation remains a major concern, since recent price and wage trends have as yet shown little response to the slowdown in economic activity.

PRODUCTION, SHIPMENTS, AND INVENTORIES

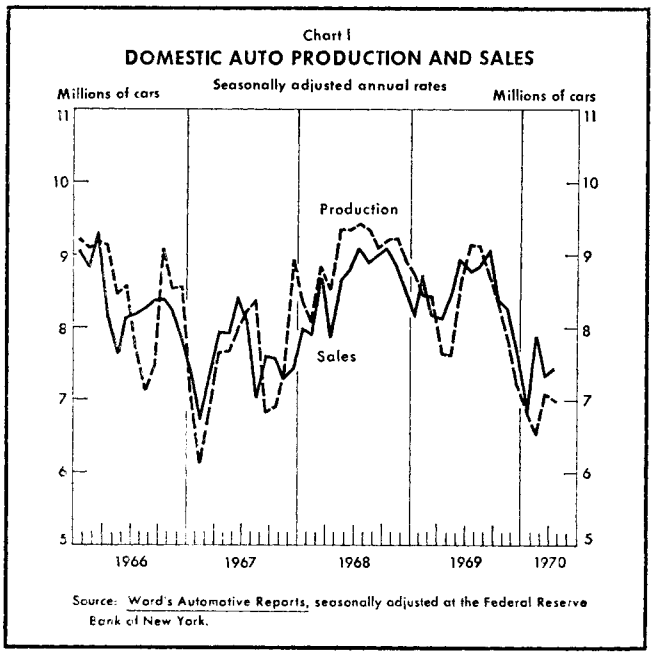
Activity in the industrial sector was sluggish in April, although the situation was accentuated by the strikes and lockouts in the trucking industry that reduced supplies of component parts used in production lines. Following two months of increase, the Federal Reserve Board's index of industrial production slipped 0.4 percent on a seasonally adjusted basis and fell back to the January low of 170.4 percent of the 1957-59 average. Thus, in contrast to the 2.0 percent slide in the production index between the July peak and last December, the index has basically moved sideways so far this year. The April decline was centered in the equipment category, where output of both business and defense industries fell. Defense output has been moving down since mid-1968 and is currently running at a rate that is more than 20 percent below its high. The materials index was a bit lower in April, despite an increase in iron and steel output. Steel ingot production—which accounts for about half the iron and steel index—was up 4 percent in that month, but preliminary data indicate steel production in May fell off by about the same amount. Consumer goods output was about unchanged in April, but the number of passenger cars produced eased to a seasonally adjusted annual rate of 7 million units. The dip in passenger car output was temporary, and auto assemblies in May rose 15 percent to a seasonally adjusted annual rate of 8 million units. Production schedules point to a further small rise in June. Although it appears that the recent slump in automobile sales bottomed in January (see Chart I), car buying has remained depressed relative to the levels of recent years. In March, April, and May, sales averaged a seasonally adjusted annual rate of about 7½ million units, compared with last September's peak of 9 million units and a low of 6¾ million units reached in January.

The flow of new orders received by manufacturers of durable goods rose slightly in April after falling sharply the month before. For the first four months of the year,

durables orders averaged $29.0 billion, $2.1 billion below the fourth-quarter average. The continuing weakness in durables orders has resulted in a decline in the backlog of unfilled orders, which in April reached the lowest level in seventeen months.

The backlog has fallen because the pace of durables sales has outstripped the flow of orders, even though the sales rate has been declining. In April, sales by durables manufacturers were the slowest in a year. Shipments of nondurables producers also eased in that month, so that total manufacturers' sales fell substantially. At the same time both durables and nondurables inventories jumped, and the combination of a sales decline and inventory increase again boosted the inventory-sales ratio for manufacturers. Although the ratio stood at the highest level in three years, the problem of excess stocks was concentrated in durables manufacturing, where imbalances were widespread and where the inventory-sales ratio was the highest since early 1961.

In March, durables shipments had slumped by $700 million, accounting for all the drop in manufacturers' shipments. Trade sales had also moved lower, and the fall in total business sales amounted to about $1 billion. Total business inventories, however, rose by $300 million in March.[1]



RESIDENTIAL CONSTRUCTION AND CAPITAL SPENDING

Recent data on residential construction suggest some firming in home-building activity in contrast to last year's marked downtrend. Residential housing starts were surprisingly strong in February and March, but dipped back in April. The volume of building permits issued by local authorities rose sharply in April and, although movements in this series are sometimes erratic, this strength suggests the possibility that housing starts may be leveling out.

Business spending on plant and equipment has been considerably stronger than investment in residential construction. Recent developments, however, suggest that businesses have trimmed plans for a big increase in capital spending this year. Surveys of business plans for plant and equipment spending, taken last fall and winter by the Department of Commerce and the Securities and Exchange Commission, had pointed to a rise of about 10 percent in 1970. The latest Commerce-SEC survey, however, taken in April and May, pointed to an overall gain of less than 8 percent. Manufacturing industries accounted for almost all the cutback from earlier plans. Total manufacturers' outlays on plant and equipment are now scheduled to rise by 4 percent this year, compared with a 10 percent advance anticipated earlier. Durables producers scaled down their plans from a 10 percent increase to 3 percent. Some evidence that manufacturers were reducing investment plans had been seen in first-quarter data on capital appropriations by the nation's 1,000 largest manufacturers. Net new appropriations declined sharply, and closing backlogs fell for the first time in al-

[1] The Department of Commerce has reduced its first-quarter estimate of the inventory spending component of GNP by $2.1 billion, bringing total inventory investment for the quarter down to a rate of $0.8 billion. The Department also revised its estimate of Federal Government spending up by $2.1 billion to allow for the retroactive portion of the Federal pay raise, which was approved in April. Other small revisions were made which, when cumulated, subtracted $0.8 billion from the preliminary GNP estimate. (The preliminary GNP figures were discussed in the May issue of this *Review*.) GNP is now reported to have risen by $7.4 billion in the first three months of the year to a seasonally adjusted annual rate of $959.6 billion. Although the pay raise offset the downward revision in inventory accumulation in terms of current-dollar GNP, it added nothing to the real value of goods and services purchased. Thus, real GNP fell by $5.5 billion, $2.6 billion more than in the preliminary numbers. By the same reasoning, the Government spent more to obtain the same services, and consequently the deflator rose at a 6.3 percent compound annual rate, compared with 5.0 percent in the preliminary estimate. Although the Commerce Department allocated the retroactive portion of the pay raise to first-quarter GNP, the raise was not disbursed until April. Thus, in the national income accounts all the pay raise will be reflected in the second-quarter wage and salary figures.

most two years. Major factors underlying the cutbacks and postponements in manufacturing have included relatively low factory operating rates, the drop in stock market prices, and the continuation of tight credit conditions. Another important factor has been a substantial decline in corporate profits which in the first quarter fell by $2.9 billion, after taxes, to a $46.1 billion annual rate, the lowest since the first quarter of 1967. In contrast to the drop in manufacturers' investment plans, nonmanufacturing firms—which are generally less sensitive to cyclical changes—have not significantly revised their spending schedules. Nonmanufacturers now anticipate capital spending to run 11 percent above last year.

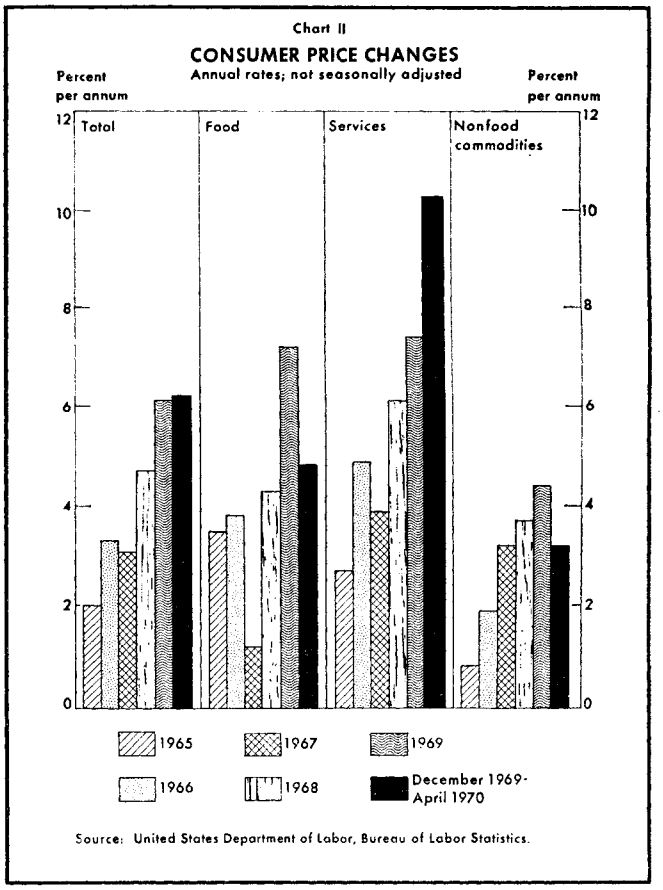
EMPLOYMENT, INCOME, AND CONSUMER DEMAND

Conditions in the labor market continued to ease in April, as the unemployment rate shot up 0.4 percentage point to 4.8 percent, the highest in five years. Employment dropped substantially in the month, and the labor force rose modestly. The April increase in the labor force was centered among adult men, while the employment decline took place in the adult men and teen-age categories. There was little change in either the employment or labor force participation of adult women.

The number of persons reported on the payrolls of nonagricultural firms declined by 88,000 in April, compared with an average monthly rise of 150,000 last year. While there were small gains in the finance and service categories and a substantial rise in government employment, reflecting Federal Government hiring of 80,000 for the decennial census, all other components recorded declines. The Bureau of Labor Statistics attributes the April drop to greater strike activity. Major stoppages included several strikes in the construction industry, the Los Angeles teachers' strike, and the strikes and lockouts in the trucking industry. Manufacturing payrolls dropped by 144,000, with most of that decline occurring in durables manufacturing. Layoffs were substantial in the automobile, aircraft, electrical equipment, primary metals, and fabricated metals industries. In manufacturing, shortages of component parts stemming from the trucking strike apparently resulted in a reduced workweek in some industries, and the overall factory workweek of production workers declined in April, falling 0.2 hour to 40.0 hours. This was the lowest since July 1964 and was 0.7 hour below the December level.

Reflecting the reductions in employment and in the workweek, private wage and salary incomes in April fell by $1.6 billion, the first decrease in over five years. The decline was partly attributable to the effects of the strikes in the construction and trucking industries. Half the April drop was in manufacturing. In contrast, total personal income soared by a record $17.8 billion to a seasonally adjusted annual rate of $801.1 billion. The 15 percent increase in social security benefits and the 6 percent pay raise for Federal Government employees, both of which were retroactive to January, boosted personal incomes by $12.5 billion and $6.3 billion, respectively.

The large rise in total personal incomes in April was presumably an important factor in the preliminary estimate of a sizable increase in retail sales. Consumer spending will presumably receive another boost at the end of this month with the expiration of the income tax surcharge. Aside from the impact of these special, large increases in income, retail sales have been generally sluggish since last fall. While some of this weakness has reflected the slump in automobile purchases, retail sales excluding spending at automotive outlets have not shown much growth since the autumn. The outlook for a pickup in sales is clouded by



the unknown impact of the current uncertainties over the Indochina situation and the decline in stock market prices.

THE PRICE SITUATION

Inflationary price increases at both the consumer and industrial wholesale levels have continued unabated, and there is as yet no significant evidence of cooling (see Chart II). The consumer price index rose at a 7.2 percent annual rate in April, or 6.3 percent on a seasonally adjusted basis. This brought the climb so far this year to a 6.2 percent annual rate on both an adjusted and unadjusted basis, not much different from last year's 6.1 percent gain. In April, prices of nonfood commodities as well as services rose sharply while food prices moved up at a relatively moderate rate. Higher costs of medical care, automobile insurance, and residential property taxes led the rise in service prices. For the first four months of the year, service prices have climbed at an annual rate even more sharp than last year's. In contrast, there apparently has been some slowing this year in hikes of nonfood commodity prices, although these took a big jump in April. At the wholesale level, prices of industrial commodities rose at a 4.1 percent annual rate in April. In the first four months of this year, industrial prices have advanced at a 4.2 percent rate, compared with a 4.0 percent increase in 1969. The April rise was led by higher prices for fuels, metals, lumber, and hides. Wholesale agricultural prices fell in April, offsetting the increase in the index of industrial commodities, and the total wholesale price index was unchanged. The preliminary estimate of wholesale prices in May indicates that industrial prices moved up at a 4.1 percent annual rate again last month. The estimate also indicated another decline in agricultural prices.

The Business Situation

The economy has apparently eased somewhat further. Thus, industrial production, employment, working hours, and private wage and salary payments all declined in May. Although the unemployment rate dropped back to 4.7 percent in June, employment fell again, resulting in the first three-month decrease in seven years. Despite the evidences of weakness, the prospects remain reasonably good for renewal of growth in the economy in the not-too-distant future. Contrary to widespread reports of consumer pessimism, the available sales data suggest that consumers have in fact responded to recent Government measures bolstering incomes. An additional boost to spendable income occurred on July 1, when the remaining 5 percent tax surcharge expired. Similarly, housing permits have been rising of late and, with an improved flow of funds into savings institutions, some strengthening in residential construction outlays seems likely in the last half of the year. Moreover, state and local spending will almost certainly continue upward in the coming months. According to the latest Government survey, business plans for an increase in plant and equipment spending this year have been cut back somewhat. This was to be expected, however, and the cuts reported have not been drastic, with spending plans outside manufacturing holding up quite well. Inventory spending has been reduced sharply in 1970 and, while there are still some areas of excess inventory, the greater part of the adjustment in this sector may have been completed. Finally, the policy actions taken by the Federal Reserve earlier in the year have resulted in moderate growth in the money supply and bank credit so far this year, in contrast to little or no growth in the last half of 1969. The recent decision to suspend Regulation Q ceilings on short-dated large certificates of deposit[1] will also help to maintain an adequate overall flow of credit. Inflation remains a most serious problem. There have been a few encouraging signs here and there, but the major price indicators have not as yet shown convincing evidence of a more moderate trend.

PRODUCTION AND ORDERS

Industrial output in May recorded one of the larger declines in the downtrend that began last July. The Federal Reserve Board's index of industrial production dropped by 0.8 percent to 169.0 percent of the 1957-1959 average (seasonally adjusted). This was the lowest level since December 1968 and was 3.2 percent below last July's high. The downtrend had been interrupted last February and March by a small recovery, which had led some observers to believe that the production slump had bottomed out. Recent production data have been difficult to interpret, since the figures have been heavily influenced by labor disputes. The February settlement of the General Electric strike helped boost production in March, and in both April and May work stoppages by truckers caused shortages of some component parts used in production lines. Strikes in the rubber industry also dampened production in May. However, the May decline in the overall production index was widespread.

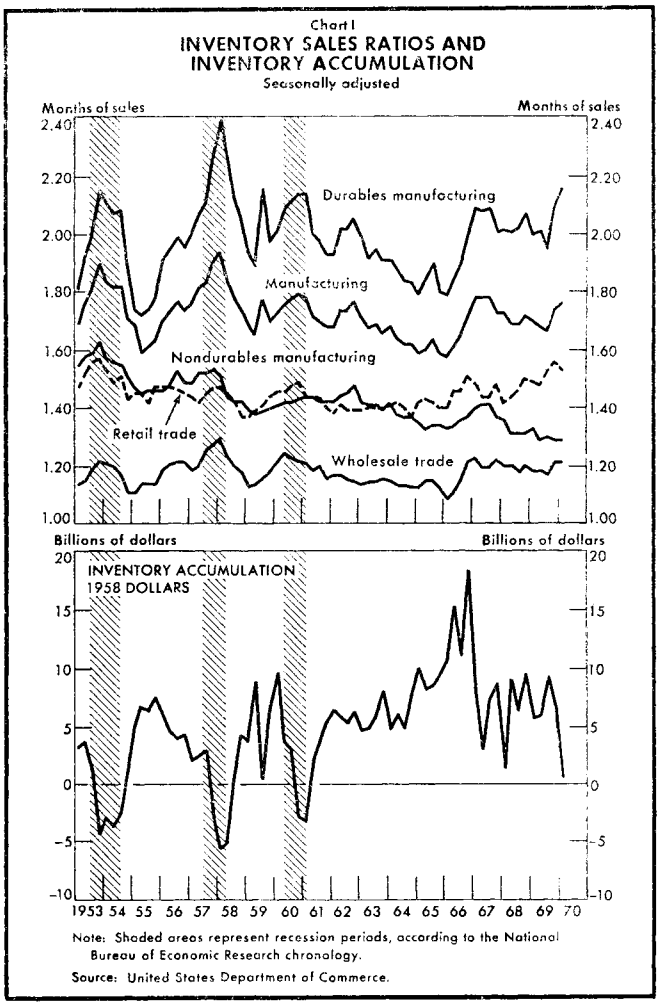
The big drop in the index occurred among equipment producers. Output among defense industries fell again, reaching a level almost 20 percent below last year's average. Production of business equipment also dropped in May, falling to a level about 6 percent below last October's peak. Iron and steel output eased in the month, although steel ingot production, which accounts for about half the iron and steel index, moved up in June. Recent levels of iron and steel output have run almost 10 percent below last year's peak, and there have been newspaper reports that some price concessions are being made.

In contrast to the general easing, auto output jumped 15 percent in May to a seasonally adjusted annual rate of 8 million units. This uptrend continued in June, when out-

[1] See "Money and Bond Markets in June", this *Review*, page 154.

put rose further to 8½ million units. The recent strength in auto production followed several months of slackening. In the second quarter, assemblies averaged 7¾ million units, compared with 6¾ million units in the first three months of the year and 7¾ million units in the final quarter of last year. The recent uptrend largely parallels the recovery in auto sales. After bottoming at a seasonally adjusted annual rate of 6¾ million units in January, the sales pace for domestically produced cars has risen rather steadily, reaching 7¾ million in May. In June, sales advanced sharply to an annual rate of 8½ million units. Better auto sales have led to a reduction in dealers' inventories. By May, the inventory-sales ratio for dealers had fallen back to the 1969 average.

The volume of new orders for durable goods, a leading indicator of industrial activity, rose $0.9 billion to a seasonally adjusted rate of $29.6 billion in May, as orders for transportation equipment—which are often erratic—surged. Durables orders have generally been weak since last fall, however, and even the strong May advance left orders at a level $2.5 billion under the September 1969 peak.



INVENTORIES, SHIPMENTS, AND RESIDENTIAL CONSTRUCTION

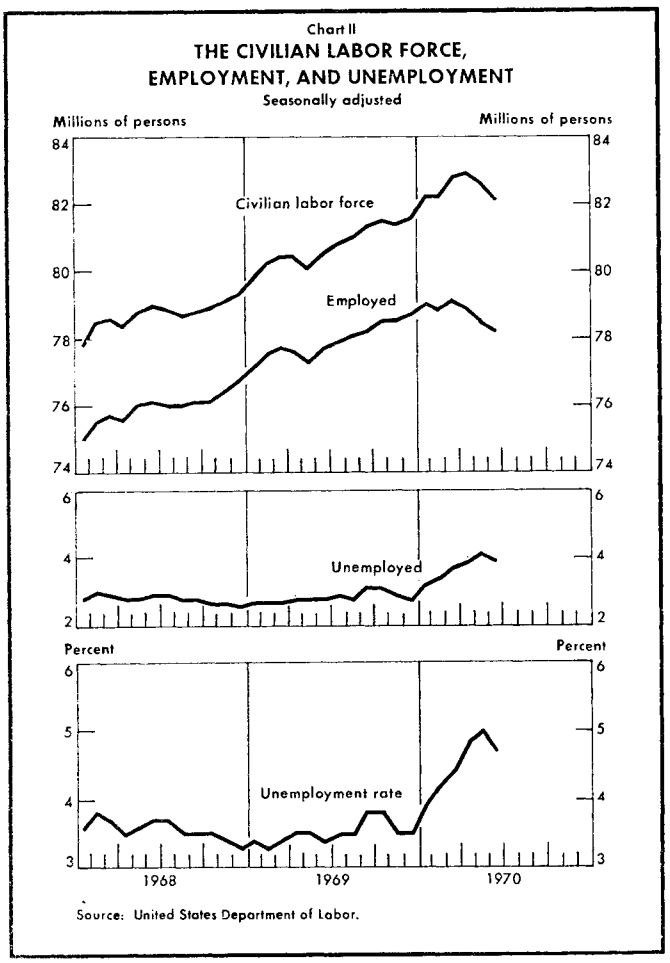
Business inventory accumulation apparently continued at a slow pace during the first two months of the second quarter. In April, total business inventories rose by $700 million. While this was above the average gain of the first quarter, it was well below the $1 billion average monthly increase of last year. Moreover, a part of the April rise apparently resulted from the truckers' strike which interrupted shipments that month. May data, which are available for manufacturing only, indicate that manufacturing inventories did not rise at all that month. Despite the small advance in inventory spending this year, there are some areas where stocks still appear to be high in relation to sales. As has generally been the case in past slowdowns, this problem is centered in durables manufacturing, where the inventory-sales ratio in May was only slightly improved from the first-quarter level shown in Chart I.

Residential construction activity continued sluggish in May, but there were some indications that the situation might improve. The volume of private housing starts remained at April's seasonally adjusted annual rate of 1.2 million units, compared with 1.5 million units started last year. While the starts rate continued low, the volume of building permits issued by local authorities rose for the second month in a row, reaching the highest level in a year. The recent strength in this series suggests some pickup in building activity in the coming months. Underlying demand for new housing—as shown by near-record lows in vacancy rates and by the rapid growth of household formations in recent years—remains very strong. Moreover, the outlook for home building has been improved by higher deposit inflows to thrift institutions and also by the likelihood of increased Federal assistance to the home mortgage market.

EMPLOYMENT, INCOME, AND CONSUMER DEMAND

The economic slowdown has been very evident in the labor market (see Chart II). Over the first six months of the year the unemployment rate increased from 3.5 percent to 4.7 percent, according to the household survey of employment. A part of this increase reflected declines

in employment, but an unusually rapid expansion in the civilian labor force also added to the pool of those unsuccessfully seeking work. This acceleration in the labor force was rather unexpected, since a softening in job markets generally leads to a slowdown or an outright reduction in labor force growth as many persons, particularly women and teen-agers, simply leave the labor force after losing a job. (To be included in the civilian labor force, as officially defined, a person must be employed or have actively sought employment within thirty days prior to the survey date.) While the explanation for the labor force acceleration earlier this year is not completely clear, the labor force did revert to more normal behavior in May and June, dropping on a seasonally adjusted basis by a sharp 750,000 in the two months and wiping out better than half the 1.3 million gain registered in the January-April period. The two-month decline was almost entirely accounted for by adult women and teen-agers. In June, teen-agers evidently entered the job market in substantially less than usual numbers, perhaps discouraged by widespread reports that summer employment would be scarce this year. (Spokesmen at the Bureau of Labor Statistics, however, have warned that seasonal factors are particularly difficult to assess in June.) Also in June, seasonally adjusted employment of adult women rose; as a result, total employment did not drop as fast as did the labor force. Thus the unemployment rate fell back 0.3 percentage point from its five-year high of 5.0 percent registered in May.



The payroll series on employment, which is a survey of employers rather than of households, also pointed to large employment declines in May and June. The total decrease in those two months amounted to 0.5 million, with over 0.3 million of that taking place in manufacturing. Since manufacturing employment peaked last September, the number of persons on manufacturers' payrolls has dropped by 0.8 million, with most of the decline accounted for by durables industries. The workweek of production workers in manufacturing also eased 0.2 hour in May to 39.8 hours, almost a full hour below last year's high, and remained unchanged at this level in June.

Declines in employment and the workweek led to decreases in private wage and salary payments in April and May (June data are not yet available). However, this weakening has been offset by Federal Government actions which have maintained the overall growth of personal income. Total personal income rose by a record $18 billion in April, and declined by $8 billion in May to a seasonally adjusted annual rate of $794 billion. April income had been given a tremendous boost by the 6 percent Federal Government pay raise and the 15 percent social security hike, both of which were retroactive to January. The social security increase alone had added $12½ billion to April incomes, and $8 billion of that represented nonrecurring makeup payments. These makeup payments were absent in May and accounted for the April-to-May decline in total personal income. (The retroactive portion of the 6 percent Government pay raise granted in April was divided equally between April and May and amounted to $3 billion in each month.) The pay raise and the hike in social security payments were large enough so that they not only masked the decline in private wage and salary disbursements, but they even brought the recent growth of personal income to nearly the same rate as last year. Over the first five months of the year total personal income rose at a 7.1 percent annual rate, only a shade below last year's 7.6 percent advance.

Federal actions underpinning personal income were generally expected to stimulate consumer buying, and the

limited figures so far available are at least consistent with this view. Retail sales in April climbed by $0.6 billion and in May backed off only slightly from that high level. The fragmentary evidence so far available for June, including the strong performance of auto sales noted earlier, suggests that overall sales may have been rather well maintained in the month.

RECENT PRICE DEVELOPMENTS

There has been little solid evidence to date of a general slowdown in the rate of price advance. The consumer price index climbed at a 6.3 percent seasonally adjusted annual rate in May, virtually the same as the rate of increase for all of 1969 and for the first four months of this year. To be sure, without seasonal adjustment the index in May increased from the April level at a more moderate 5.4 percent annual rate, but this statistic is less meaningful than the adjusted figure since some prices, such as those for food, are normally a bit lower in May than in April.

Industrial wholesale prices have also continued to gain rapidly despite wide expectations of easing. In May industrial prices rose at a 4.1 percent annual rate, compared with a 4.2 percent rate in the first four months of the year and a 4.0 percent hike in 1969. A good part of the May rise occurred in prices of fuels, lumber, and iron and steel products. There was a slowing in the rate of advance in industrial prices in June, but this apparently reflected little more than a normal seasonal development. In contrast to the uptrend in industrial prices, the total wholesale price index has risen slowly so far this year, as declines in agricultural prices—which make up a quarter of the total index—have offset most of the advance in industrial costs. The agricultural declines suggest some letup in the rise of consumer food prices, but the current inflation is rooted in developments clearly outside the farm sector.

Recent trends in labor compensation and productivity suggest labor costs will continue to exert pressure on the price level. When increases in compensation per man-hour are not matched by equal gains in productivity (output per man-hour), the labor cost per unit of output rises. Since 1965, gains in compensation per man-hour have outstripped productivity increases and have pushed up unit labor costs. These advances have been major factors in the current inflation. So far this year the situation has shown little improvement, except in the manufacturing sector where layoffs and reductions of expensive overtime work have helped to hold down costs.

The Business Situation

The economy drifted unevenly in the second quarter. Industrial production and employment fell throughout the April-June period, although real output of the economy as a whole was virtually unchanged after two quarters of decline, according to the preliminary estimate. Some June indicators furthermore suggested a flattening or perhaps even some renewed advance. Durables new orders and shipments stayed at their improved May level. Housing starts advanced after earlier increases in permits and scattered signs of a better financing picture. Auto sales and output gained further, following a slump last fall and winter that had been an important factor in the economic slowing. Evidently the various Federal actions bolstering personal income within the quarter had their expected effect on spending. Total consumer outlays continued to advance at around the first-quarter rate despite the lack of growth in private wage and salary payments. In July, disposable income was boosted by the expiration of the income tax surcharge and by the increase in the personal exemption. Financial conditions also seem favorable for some renewed growth in real output. The money supply continued to advance at a moderate pace in the second quarter, and financial markets have become noticeably calmer, with substantial declines taking place in a wide spectrum of interest rates over the past several weeks.

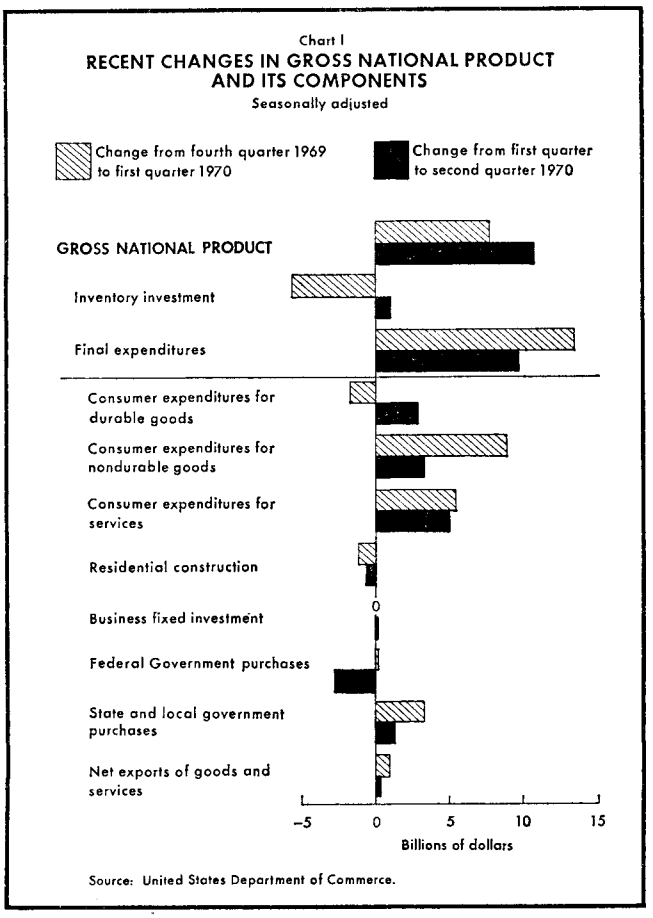
Despite some scattered and hopeful signs of improvement in the price picture, solid evidence of a real slowdown in the rate of inflation is still lacking. The apparent sharp reduction in the rate of growth of the GNP deflator during the second quarter largely represented technical factors rather than a real improvement. In July, the wholesale price index jumped sharply as agricultural prices surged. In June and July, some moderation in the rate of advance in wholesale industrial prices mainly reflected seasonal factors. While the rise in the consumer price index slowed to a 4½ percent seasonally adjusted pace in June, such one-month slowdowns have occurred before and subsequently proved to be false signals. Rising productivity in manufacturing has helped to hold down the advance in unit labor costs in that sector, but the pay increases won in recent collective bargaining settlements have far outpaced any conceivable further progress in productivity and extend to industries in which there is no evidence of significant productivity gains. In short, the inflation problem is still very much with us.

GROSS NATIONAL PRODUCT IN THE SECOND QUARTER

The real value of the nation's output of goods and services was virtually unchanged in the second quarter, although continued price increases led to a rise in the market value of the nation's product. Coming on the heels of two successive quarterly declines, the approximate stability of real gross national product (GNP) in the April-June period gave rise to the hope that the downtrend of the previous six months had ended. According to the preliminary estimate of the Department of Commerce,[1] current-dollar GNP rose by $10½ billion (see Chart I) to a seasonally adjusted annual rate of $970 billion. Excluding price increases, GNP edged up by a scant 0.2 percent annual rate. In the October-March period, real GNP had fallen at a 2.0 percent annual rate.

The GNP deflator—which is the broadest measure of price trends in the economy—rose at a 4 percent annual rate, compared with a 6½ percent increase in the first quarter. This decline did not indicate an easing in basic inflationary price trends, for it mostly reflected technical factors that boosted the rate of advance in the first quarter

[1] The Commerce Department's annual midyear revisions of the national income and product accounts reduced GNP for the fourth and first quarters by $0.5 billion and $0.1 billion, respectively, to seasonally adjusted annual rates of $951.7 billion and $959.5 billion. The GNP estimate for 1969 was revised down by $0.7 billion to $931.4 billion. For 1968, GNP was reduced by $0.7 billion, bringing the total for that year to $865.0 billion. GNP for 1967 was revised up by $0.4 billion to $793.9 billion.



and lowered it in the second quarter. The deflator climbed at an unusually high rate in the first quarter because the Federal Government pay raise, which added nothing to real output, did increase outlays.[2] The lower second-quarter rate largely resulted from a shift in the composition of demand. This change in composition affected the total GNP deflator, which is the weighted sum of deflators for individual components. The weights are equal to each component's share of total GNP in the period under consideration. In the first quarter a relatively large proportion of GNP was spent in components with high deflators, but in the April-June period there was a shift in spending to components having lower deflators. If these technical factors—the shift in the composition of spending and the impact of the pay raise—are ignored, the resulting GNP deflator would have risen at an annual rate of about 5 percent in both quarters. On a monthly basis, consumer prices and industrial wholesale prices rose less steeply as the quarter ended, but it is still too early to tell if this letup indicates a basic change in trend. In June, consumer prices rose at a 4½ percent seasonally adjusted annual rate, compared with a 6 percent rate in the first five months of 1970. The easing reflected a decline in seasonally adjusted food prices. Prices of nonfood commodities and of services—which are much more indicative of inflationary pressures than are food prices—continued to advance sharply. Industrial wholesale prices rose slowly in June, but spokesmen at the Bureau of Labor Statistics attributed the slowdown to seasonal declines. Preliminary data for July indicate that industrial wholesale prices advanced at a faster rate than in June and that there was a big jump in agricultural prices.

The stronger performance of total GNP in the second quarter reflected a turnaround in inventory spending. Based on incomplete data,[3] net inventory spending is estimated to have increased by $1 billion to a $2½ billion annual rate, which is still a very low level of accumulation. The $1 billion increase in April-June followed declines totaling $10 billion in the final quarter of 1969 and the first quarter. While this drag was the main cause of the GNP slowdown in those two quarters, the adjustment was much milder than in the mini-recession of 1967, when inventory accumulation fell by $15 billion in six months. Inventory accumulation was kept at a slow pace over the first half of this year, as businessmen continued to bring stocks into a better line with sales. Inventory-sales ratios—particularly among trade firms—improved over the first two months of the quarter, but some modest imbalances still exist among durables manufacturing firms despite progress during the second quarter in reducing inventory-sales ratios. In general, cuts in inventory spending in response to sluggish sales patterns have prevented any major imbalances in inventory-sales positions from

[2]The pay raise was enacted in April but was made retroactive to January. The retroactive portion of this increase was treated differently in the GNP accounts than it was in personal income. In GNP, the retroactive part was included in first-quarter spending, as if it had been a simple pay raise beginning in January and continuing on at that new level. In terms of personal income, however, the retroactive portion of the raise was included in wage and salary payments for the second quarter, when these payments were actually disbursed. Thus, the increase in personal income in the April-June period reflected the actual pay raise plus a nonrecurring bulge due to the back payments.

[3] In the preliminary GNP numbers, the inventory component is estimated from data for the first two months of the quarter. Thus, this component is particularly subject to revision.

developing. Unless there is a deterioration in sales, the recent adjustment in inventories may prove to have run its course.

Final expenditures, which exclude the inventory component from GNP, advanced at a slower pace than in the first quarter, chiefly because of a moderation in the government sector. Federal Government spending declined by over $2½ billion, with most of this drop arising from cuts in defense spending. A similar decline would have taken place in the first quarter but for the Federal employee pay raise. While expenditures by state and local governments rose in the second quarter, the quarterly increase was the smallest in six years. Spending was dampened by delays in construction projects, which partly reflected the continued financing difficulties faced by many state and local governments and the effects of trucking strikes.

Consumer spending rose by about $11 billion in the second quarter. This increase was actually slightly larger than in the first quarter despite the general weakness in private income payments during the April-June period that resulted from cutbacks in both total employment and the workweek. The impact of these cutbacks was more than offset by two government actions that in fact caused a record increase in personal and disposable incomes in the second quarter. Thus, the Federal pay raise became effective in April and the retroactive portion of the increase was also paid out in April and May. Similarly, there was an increase in social security benefit payments which began in April, with retroactive payments also being made in that month. Without these special factors, personal income would have changed little over the April-June period.

While all broad categories of consumption spending rose in the second quarter, the most notable increase was in the durables sector, where consumer spending had actually fallen in the first quarter of the year. The major factor in this turnaround was the partial recovery of new car sales from their January-March slump. In addition to the renewed growth of auto sales, the outlook for consumer spending in the current quarter is strengthened by the boost to disposable income that resulted from the July 1 expiration of the surtax.

Business fixed investment was about unchanged over the first half of the year. Although recent surveys of plant and equipment spending plans for this year had pointed to a small increase (and earlier surveys to a fairly strong rise), the actual spending figures for the first and second quarters suggest that capital investment may not contribute much to GNP growth this year. Weak profits, the uncertain sales picture, and excess capacity are important factors tending to dampen the near-term outlook for capital outlays. In addition, tight money and the growing concern over corporate liquidity positions may have caused some corporations to reexamine their borrowing and investment plans.

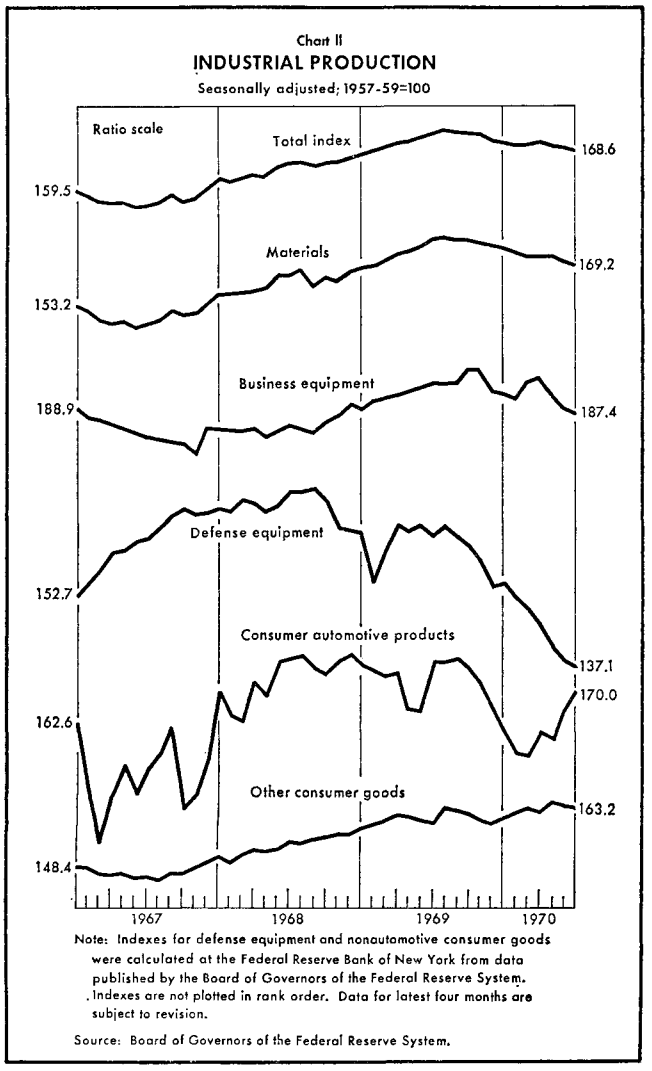
Investment in residential construction was again a drag on the growth of current-dollar GNP, but the second-quarter decline was small—amounting to $½ billion, compared with a drop averaging over $1½ billion in the three previous quarters. The moderate size of the second-quarter easing reflected a bottoming of the downtrend in housing starts. Starts had been falling since the first quarter of last year, when they averaged a seasonally adjusted annual rate of 1.6 million units. Since the January low of 1.1 million units, starts have been stronger—running at an annual rate of almost 1.4 million units in June. Moreover, residential building permits issued by local authorities in the April-June period exceeded the first quarter's average by 20 percent. This series tends to lead starts by several months, and thus the recent strength in permits points to a somewhat more buoyant outlook for residential construction. Improved deposit flows to thrift institutions and the likelihood of increased Federal aid have also enhanced the outlook for the housing sector.

PRODUCTION, PRODUCTIVITY, AND LABOR COSTS

Industrial activity slackened a bit further in June, as declines in equipment and construction materials outweighed increases in production of consumer automotive products. The Federal Reserve Board's index of industrial production slipped 0.3 percent in June to 168.6 percent of the 1957-59 average (see Chart II), bringing the total drop since last July's peak to 3.4 percent.

As in the two previous months, the major decline in the June index was among equipment producers. Defense production fell 0.9 percent and brought the retreat from its 1968 peak to a total of 25 percent. Defense output had soared by 75 percent between early 1965 and its mid-1968 peak. Production of business equipment dropped 0.8 percent in June. Since last October, equipment output has declined by 7 percent, a further indication that the planned rise in outlays indicated by surveys of business spending plans may have been overstated.

Production of materials—particularly for construction—moved down in June, although iron and steel output increased. Seasonally adjusted production of steel ingots advanced again in July, suggesting that the iron and steel index may be continuing to rise. In recent months, iron and steel production has been bolstered by the partial recovery of the automobile industry from the slump last fall and winter. In June, production of automotive products climbed 2.8 percent. This brought the index to a level 10 percent above



the February low, although output was still about 5 percent below the levels prevailing before the slump began. With the improvement in car sales, the outlook for auto production is good. However, labor contracts with the auto makers expire in September, and a strike appears to be at least a possibility.

The flow of new orders for durable goods, an important indicator of business activity, has apparently leveled out. Orders volume had fallen by $3½ billion between last September and March, but in the April-June period orders picked up, erasing $1 billion of that decline. The improvement in new durables orders has not yet reversed the downtrend in the backlog of unfilled orders. In June, shipments volume again exceeded the orders inflow and the backlog fell to the lowest level in almost two years.

The slowing of economic activity has particularly affected the labor markets. The most marked impact on employment has resulted from the decline in industrial activity. Since the July 1969 peak in industrial production, manufacturing employment and the factory workweek have both fallen sharply, with the number of persons on factory payrolls dropping by half a million and the workweek declining almost a full hour. The slump in total man-hours since last July has been greater than the drop in output in manufacturing, resulting in an improvement in manufacturing productivity. Although productivity is likely to grow in the coming months, recent collective bargaining settlements have called for increases in wages and benefits that far exceed any conceivable gains in output per man-hour. In the first half of this year, negotiated wage and benefit increases averaged 10 percent over the life of the contract and 15 percent for the first year.

The Business Situation

After having moved essentially sideways in late spring, the domestic economy seems to have begun the second half of 1970 on a somewhat stronger note. Housing starts recorded a substantial gain in July, while industrial production edged upward. In addition, personal income grew modestly after having shown little change in recent months apart from the effects of the recent Federal pay increase and the rise in social security benefit payments. Revised gross national product (GNP) data for the second quarter show that both prices and real output increased by fractionally greater amounts in the April-June period than was previously indicated.[1] In August, however, employment weakened and the unemployment rate edged up to 5.1 percent. On balance, the decline in business activity appears to have bottomed out, and prospects for a near-term economic expansion are brighter than a month ago. However, the strength of such an upturn is hard to assess. The possibility of an automobile strike remains an important element of uncertainty in the economic outlook.

Meanwhile, recent price movements have given rise to the hope that the pace of inflation may at last be slowing. The seasonally adjusted consumer price index rose less rapidly during June and July than earlier in the year. At the same time, the rise in industrial wholesale prices has slowed in recent months, also suggesting an improvement in the price picture. As yet, however, there is no evidence indicating a significant moderation of wage pressures.

[1] The second-quarter revisions have GNP in current dollars at a seasonally adjusted annual rate of $971.1 billion, up $1 billion from the preliminary estimates. GNP adjusted for price changes increased by 0.6 percent, up slightly from the earlier figure of 0.3 percent despite a small upward revision in the GNP deflator. A major portion of the higher GNP levels revealed in the final data comes from the $0.5 billion upward adjustment in business inventories.

PRODUCTION, ORDERS, SHIPMENTS, AND INVENTORIES

Industrial production, as measured by the Federal Reserve Board's index, registered a slight increase of 0.2 percent in July, but remained 3 percent below its high of 174.6 reached twelve months earlier. The small gain recorded this July reflected increases in output of consumer goods and materials, which more than offset further declines in the production of defense and business equipment. Defense equipment production fell 1.5 percent in July, bringing the decline over the past year to 21 percent. This drop has resulted in some severe unemployment rises in localities where defense industries are major employers. Output of business equipment has also been on a fairly long slide, peaking last October and falling in every subsequent month except the two months immediately following settlement of the General Electric strike last winter. At current levels, output of business equipment is 7 percent below the October high. The weakness in business equipment production has accompanied a progressive trimming of capital spending plans, as reported in each of this year's Department of Commerce-Securities and Exchange Commission surveys. Against the backdrop of an 11.5 percent increase in plant and equipment expenditures in 1969, the Commerce-SEC survey early this year pointed to a rise of almost 10 percent. This figure was cut back to slightly less than 8 percent with the spring survey, and the latest forecast, based on July-August data, now places the 1970 growth of plant and equipment spending at 6.6 percent. This survey indicates that spending will continue to grow at a modest rate in the second half of 1970, with virtually all the increase concentrated in the public utilities sector. After taking price changes into account, the physical volume of plant and equipment investment in 1970 will probably remain close to last year's level.

In the consumer sector the production of automobiles and home goods rose somewhat in July. Allowing for

normal seasonal factors, which at this time of year include the model changeover period, unit auto assemblies were at an annual rate of approximately 8½ million in July and August. Production schedules for September indicate that output will continue at about this pace. The volume of automobile production in subsequent months will, of course, be greatly affected by the scope and duration of a strike, if one takes place.

New orders for durable goods, which had posted gains in both May and June, rose 3.3 percent in July to a seasonally adjusted level of $30.7 billion. However, all the gain can be traced to a substantial growth in new orders for defense goods. Excluding the defense sector, new orders fell nearly 1 percent in contrast to the moderate upward trend over the previous two months. While defense orders certainly have implications for employment, prices, and output, they are not necessarily indicative of future trends in overall business activity. Moreover, on a month-to-month basis, the defense orders series has been particularly volatile, and the July increase may reflect an orders bulge at the start of the fiscal year which is not accounted for by the seasonal adjustment process. In the important producers' capital goods sector, new orders rose for the fourth straight month. Despite the rise in new orders for manufacturers' durables in July, shipments again exceeded new orders, and the backlog of unfilled orders declined for the seventh successive month.

Preliminary data indicate that total inventories in manufacturing rose by a substantial $0.8 billion in July, to a seasonally adjusted annual rate of $98.5 billion. All this increase occurred in the durable goods sector, where declines had taken place in the two preceding months. However, the rise in inventories was matched by the increase in manufacturers' sales of durables, so that the inventory-sales ratio was virtually unchanged from the fairly high June figure.

CONSTRUCTION

The housing industry is showing some signs of coming out of its recent slump. After a rather weak April, housing starts strengthened in May and June and averaged a 1,280,000 unit annual rate in the second quarter, up slightly from 1,252,000 in the first quarter. In July, seasonally adjusted starts jumped a sharp 15 percent from the June level to a 1,585,000 unit annual rate. The starts series, to be sure, is highly volatile (see Chart I), and this latest jump may exaggerate the extent of the underlying improvement. Nevertheless, there have been some basic gains in the financing situation for home construction. The flow of funds to savings and loan associations and mutual savings banks, which specialize in home financing, has strengthened notably in recent months, and net mortgage acquisitions by these institutions have begun to rise. All of July's rise in private housing starts was concentrated in multifamily dwellings, with single family starts practically unchanged at an 827,000 unit annual rate. Since the number of single family starts was particularly depressed earlier in the year, the average for the first half of 1970 was held down to approximately the 700,000 mark. In contrast, total single family private starts numbered slightly less than 820,000 during 1969.

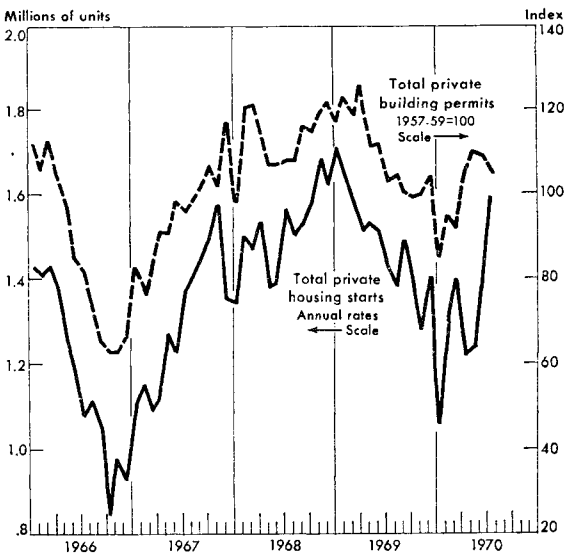
The recent strengthening of housing starts was foreshadowed, as is often the case, by an earlier gain in residential building permits (see Chart I). Permits jumped very sharply in April and edged up slightly in May to a 1,321,000 unit seasonally adjusted annual rate. Subsequently, there has been some backing-off from the May pace, but the 1,265,000 unit rate for July is still markedly above the levels registered in the first three months of the year.

In contrast to the housing starts improvement, preliminary estimates of the current-dollar value of total new construction activity fell 1 percent in July on a seasonally adjusted basis, continuing the rather steady decline of recent months. Public construction and private commercial

Chart I

TOTAL PRIVATE HOUSING STARTS AND PERMITS

Seasonally adjusted



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

buildings contributed to the decrease, while private residential and industrial buildings were both above the previous month's figures. After excluding the effects of rapidly rising prices, the volume of total construction activity is off almost 9 percent from a year earlier.

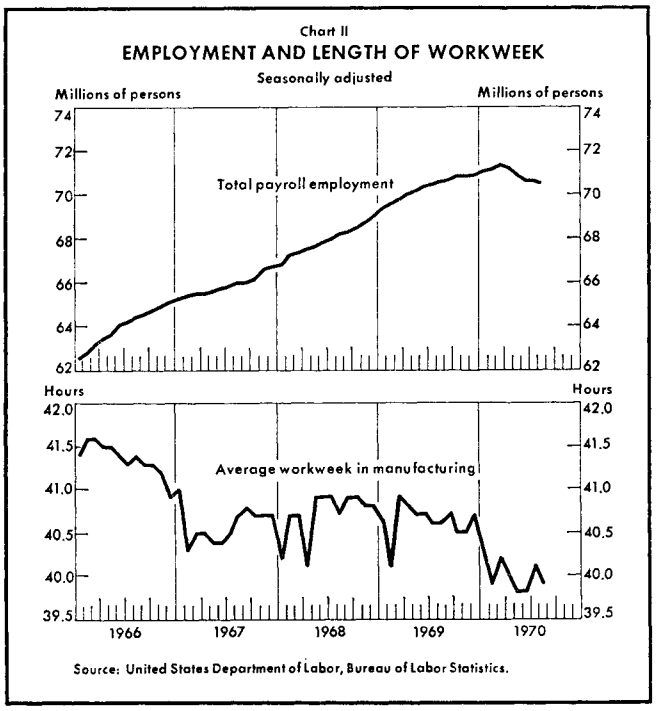
EMPLOYMENT, PERSONAL INCOME, AND RETAIL SALES

Despite recent indications of a somewhat stronger general business performance, labor markets have continued to show slack. The seasonally adjusted unemployment rate edged up to 5.1 percent in August from July's 5.0 percent. While the labor force shrank in August, a somewhat greater fall in employment pushed the jobless rate up. The small increase in the unemployment rate was concentrated among teen-agers, with the rate for adult males remaining unchanged and that for adult women declining. Long-term unemployment, i.e., the percentage of the work force out of a job for fifteen weeks or more, remained virtually unchanged in August at 0.9 percent. Although this rate has increased during 1970, it is generally considered to be a "lagging indicator". Joblessness among workers covered by state unemployment compensation programs, which usually extend insurance coverage only to experienced members of the labor force, moved back up to the June rate of 3.7 percent after dipping in July.

The August monthly payroll survey indicated that the number of employees on nonagricultural payrolls slipped after the small July increase shown by the revised data (see Chart II). In recent months, employment has fallen off in the construction, manufacturing, trade, and finance sectors, with the decline being longest and most severe in manufacturing.

Since employers tend to adjust the hours worked by their employees before varying the total number of workers on their payrolls, the length of the manufacturing workweek is often viewed as a leading indicator of business conditions. The index has, however, behaved erratically in recent months (see Chart II). During August, the seasonally adjusted workweek in manufacturing fell 0.2 hours, partially reversing the 0.3 hour rise in July. Nevertheless, the 39.9 hour workweek for August was still above the levels for May and June of this year.

Personal income rose by $3.6 billion in July. Excluding the Federal pay raise and the improvement in social security payments, personal income had grown by an average of only $1.3 billion per month in the second quarter. Thus, the July increase, while still smaller than the roughly $5 billion per month average growth experienced in the first half of 1969 prior to the economic slowdown, nevertheless represents an improvement over the weak performance registered in the second quarter of 1970. However, Federal actions did supply massive injections of income during the April-June interval. As a consequence, the actual climb in personal income, including the Federal payments, averaged $3.5 billion per month in the period. Consumer spending responded with a large 2.5 percent quarterly increase in retail sales, and during July—perhaps bolstered by the final elimination of the surtax—retail sales rose a further $0.2 billion from June, or 0.7 percent over the second-quarter average. Better new car sales have been an important element in the pickup of consumer buying, with the seasonally adjusted annual rate of sales of domestically produced automobiles rising from about 7.4 million in the first quarter to 7.9 million in the second quarter. Over July and August, auto sales averaged approximately 8½ million units.



PRODUCTIVITY, COSTS, AND PRICES

During the second quarter of 1970, the combined impact of higher average output per man-hour and a slower average rate of increase in hourly compensation led to a slowdown in the average rate of increase in labor costs per unit of output. As measured by the change in output

per man-hour, productivity in the private nonfarm economy rose at a 3.3 percent seasonally adjusted annual rate during the second quarter, after having fallen at a 2.9 percent rate in the first three months of 1970 and a 0.2 percent rate over the four quarters of 1969. The second-quarter rise in productivity reflected the combination of an essentially unchanged aggregate output and a substantial 3.3 percent drop (annual rate) in man-hours. Clearly, employers were less inclined to hoard labor in the second quarter than they had been earlier in the economic contraction and thus began to release workers made redundant by the lower output rates.

Average compensation per man-hour in the private nonfarm economy, including both wage and benefit payments, slowed to a 5.6 percent annual rate of increase in the second quarter, down from 6.6 percent in the preceding three months and from 6.6 percent in the four quarters of 1969. The slower rate of gain in the April-June period this year reflected a cutback in expensive overtime hours and the economic contraction that has tended to be concentrated in industries with relatively high rates of compensation. Thus, a reduction in these industries' share of total output has helped to pull down the overall average rate of compensation. However, wages and salary benefits negotiated in recent major labor contract settlements have suggested, if anything, an acceleration rather than a slowdown in the rate of increase.

The second-quarter combination of productivity gains and smaller average rates of increase in compensation brought about a slowdown in the average rate of increase of labor costs per unit of output. During the second quarter, unit labor costs in the private nonfarm economy rose at a 2.2 percent seasonally adjusted annual rate, down sharply from the 9.8 percent gain during the first three months of the year and the 6.8 percent rise averaged over the four quarters of 1969.

A slower rate of growth in consumer prices during June and July has raised hopes that the pace of inflation may at last have begun to ease. The consumer price index rose at a 4.2 percent seasonally adjusted annual rate in June and at a 3.4 percent rate in July. Both months represented an improvement over the 6.3 percent rate of growth registered in the first five months of 1970 and the 6.1 percent rate recorded in 1969. Retail prices of food, other goods, and services have all risen less rapidly lately, but the most clear-cut movement in the desired direction has been in food prices. On a seasonally adjusted basis, the food component of the index actually declined in June and was little changed in July. These favorable developments had been foreshadowed somewhat earlier by a generally downward trend in wholesale farm prices, which began around April and has been extended through August. Farm prices, however, are heavily influenced by agricultural supply factors and are not necessarily good indicators of price conditions elsewhere in the economy. Moreover, the recently reported appearance of a corn blight has apparently dampened prospects for further declines in wholesale food prices over the coming months.

The most recent slowdown in the overall consumer price index is certainly encouraging. Unfortunately, however, it is necessary to keep in mind that other similar intervals of improvement were quickly reversed. For example, a decline in the rate of price increases during July and August 1969 was followed by an acceleration in the rate of increase. The cooling effects of the economic slowdown are a major reason for hoping that the current easing will prove more lasting. The balance between supply and demand is now markedly less favorable to rapid price increases. Weaker demand has apparently been a factor in the recent easing in prices for some nonferrous metals, thus contributing to the somewhat slower growth of industrial wholesale prices in the June-August period.

The Business Situation

The strike at General Motors Corporation, which began in mid-September, will greatly complicate for some time to come the task of assessing the underlying business situation. This situation was, in any event, already rather mixed before the strike began—as perhaps should be expected of an economy that is apparently no longer declining but which has yet to resume a clear-cut upward trend. The rise in the unemployment rate to 5.5 percent in September and the drops in average weekly hours worked and in overtime were disturbing, although these figures have been adversely affected by technical problems of seasonal adjustment. Elsewhere in the economy, there are some indications of increased strength. While housing starts backed down in August from their July high, they remained well above the average over the first half of 1970. Private housing construction permits were up in August and substantially ahead of the pace during the first six months of 1970. The considerably easier credit conditions that have characterized the third quarter[1] should channel additional funds into housing and should also help state and local governments finance greater expenditures. Personal income posted a fairly good gain in August, and retail sales were higher in the first two months of the third quarter than earlier this year.

Price increases for consumer goods and services, as well as those for wholesale industrial commodities, have begun to show encouraging signs of moderation and to provide tangible evidence of gains in the struggle against inflation. The prices of wholesale agricultural products, however, rose sharply in September, wiping out much of the improvement in this sector that had appeared during preceding months. Furthermore, there is a distinct danger of an inflationary contract settlement in the automobile industry, which could put increased pressure on wage settlements in other sectors and ultimately on price levels.

[1] See "The Money and Bond Markets in September", this *Review*, pages 227-33.

RESIDENTIAL CONSTRUCTION

Although private housing starts in August fell to a 1.43 million unit seasonally adjusted annual rate from the 1970 peak of 1.59 million units reached the previous month, the housing outlook is appreciably stronger than earlier in the year. If September housing starts remain close to the July and August average, the third quarter of 1970 will be the best since the second quarter of last year. Residential building permits, an important indicator of the future trend in housing starts, made an encouraging upward move during August, reversing the downward thrust of the previous two months. Over the July-August interval, newly issued permits were running about 10 percent ahead of the average during the first half of this year and only slightly behind the 1969 level. The backlog of unused permits rose considerably during the first half of 1970 and remained high even after falling in July and August. Continuing improvement in the availability of mortgage funds would help translate this backlog into actual housing starts, providing a source of strength for residential construction in coming months.

SALES, INVENTORIES, AND NEW ORDERS

Another possible source of strength is retail sales. Even though advance estimates for August, which are subject to large revisions, suggest some slippage from the comparatively vigorous July pace, retail sales have been moderately strong. Over July and August, seasonally adjusted retail sales averaged approximately $30.7 billion, compared with the $30.5 billion and $29.7 billion averages for the second and first quarters of 1970. Automobile sales were sluggish in September, with one of the probable causes being the auto strike. Nevertheless, third-quarter auto sales suggest a seasonally adjusted annual pace in excess of 8 million units, ahead of the 7.6 million unit rate of sales during the first six months of the year.

Brisk sales in July kept the inventory-sales ratio for total business essentially unchanged from the 1.57 June

rate, despite a $1 billion climb in total business inventories on a seasonally adjusted basis. Most of the increases in total inventories and shipments were for manufacturers of durable goods. For retail outlets, inventories changed little relative to sales, although the inventory-sales ratio for retail automotive outlets rose. (A most likely impact of a sustained strike in the automobile industry would be to lower this ratio.) August data are available only for the manufacturing sector. Manufacturers of durables increased their inventories considerably less in August than in July. Their August shipments grew less than proportionately, so that the inventory-shipments ratio rose. For nondurable goods manufacturers, both July and August have been marked by inventory decumulation and smaller shipments; their inventory-shipments ratio, which had remained stable in July, rose during August.

After three monthly gains in a row, new orders for durable goods dropped $0.8 billion in August to a seasonally adjusted $30.6 billion. Even so, the August level was ahead of all previous months in 1970 with the exception of July. The August decline was primarily in new defense orders and followed the large increase in July, which marked the start of the 1971 fiscal year. Excluding defense, new orders for durable goods rose during August and were running $1.0 billion ahead of the average for the first seven months of the year. In the closely watched producers' capital goods sector, new orders fell $0.3 billion, almost back to the April level. For durable goods industries as a whole, new orders declined faster than shipments in August. As a result, the backlog of unfilled orders dropped $0.8 billion to $80.5 billion, with the producer capital goods sector accounting for $0.5 billion of the decline. The backlog of unfilled orders has fallen in each month of 1970, with the exception of July which was heavily influenced by the surge in new defense goods orders.

INDUSTRIAL PRODUCTION AND STRIKE ACTIVITY

The Federal Reserve Board index of industrial production edged down in August, erasing about half the July gain. Output in August was off 3.2 percent from the peak reached in July 1969. Of the major industry groupings, only mining output, which often moves erratically on a month-to-month basis, rose as a result of increases in gas and oil production. The rather small decline in manufacturing was centered in durable goods, particularly iron and steel. Production of consumer goods was slightly below the July level and that of equipment, including defense, slipped for the fifth consecutive month to a level nearly 10 percent below the high reached in September of last year.

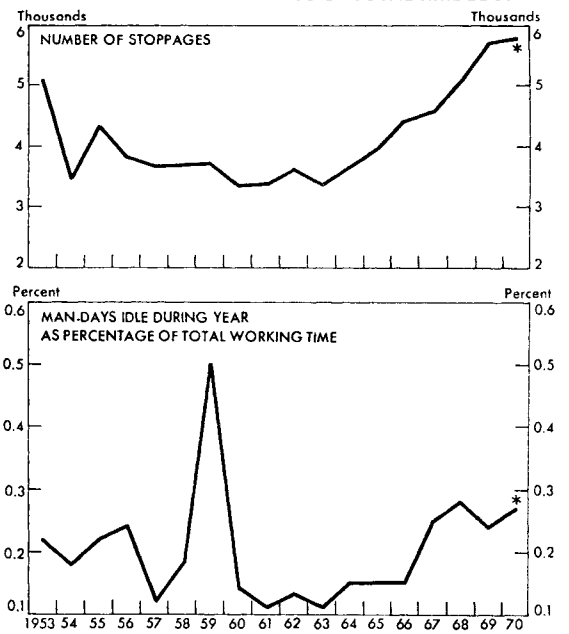
One important question currently facing the economy is how industrial production and business activity in general will fare in the wake of the auto strike that started in mid-September, for a prolonged dispute might adversely affect the timing and size of the expansion. Further labor uncertainty stems from the possibility of nationwide rail tie-ups that could have large secondary effects.

Each of the major automobile strikes during 1961, 1964, and 1967 seems to have been preceded by a quickening in the pace of automobile production and to have been closely followed by a surge in output. Extra production before and after the strikes apparently compensated for the losses during the disputes. The impact of the current dispute cannot, however, be predicted with any certainty from these earlier experiences, which occurred when the economy had already developed considerable upward momentum. In contrast, total industrial production and some other major economic indicators have not as yet established a clear-cut upward trend.

Overall strike activity has increased during the past sev-

Chart I

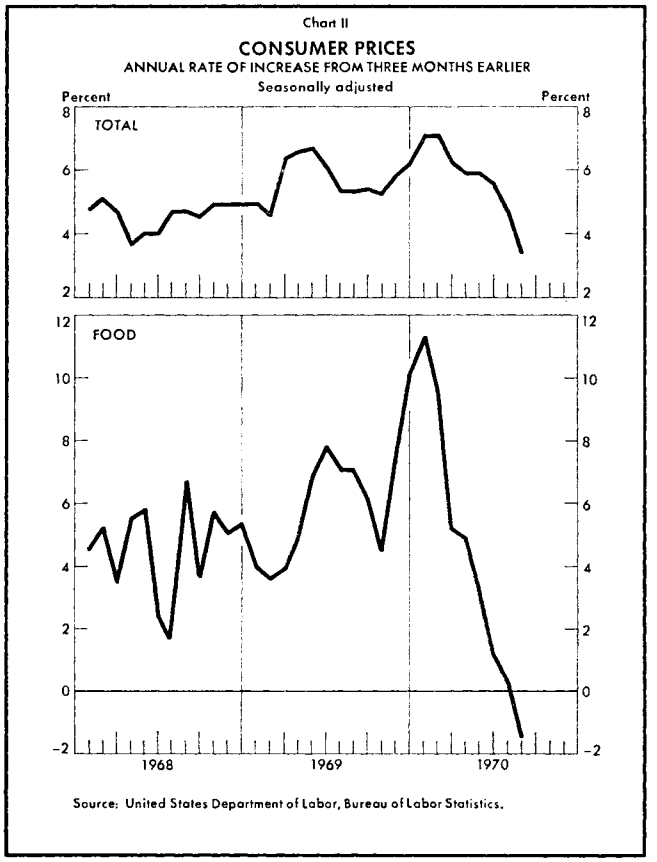
WORK STOPPAGES RESULTING FROM LABOR-MANAGEMENT DISPUTES AND PERCENTAGE OF TOTAL TIME LOST



* First half of 1970 at an annual rate.

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

eral years. Chart I depicts the number of disputes and the percentage of total working time lost by the employees directly involved in these stoppages beginning in each year since 1953. Available data cover only the first six months of 1970, and developments emerging over the final half of the year may be worse in view of the potentially large impact of the automobile dispute. (The huge 1959 increase in time lost is directly attributable to the 116-day steel strike, involving over half a million workers, which ended after the eighty-day "cooling off" period of the Taft-Hartley Act was invoked.) It should be noted that 1969 was characterized by a relatively "light" collective bargaining schedule, since approximately 2½ million of the roughly 10 million workers covered by "major" agreements[2] were engaged in negotiations. This year, in contrast, the number of workers whose contracts are up for renewal is closer to 5 million. Labor demands in these negotiations have been influenced by expectations of continuing inflation. Recent movements in the cost of living, however, offer some hope that the pace of price increases is at last slowing. Yet, an inflationary settlement of the auto strike could place additional pressure on wage demands in forthcoming labor negotiations.



PRICES

The seasonally adjusted consumer price index for August rose at a moderate 2.7 percent annual rate, the third consecutive monthly slowdown in the rate of increase. An important contribution to the August improvement on a seasonally adjusted basis was made by food prices. The rate of change in food prices, as measured by percentage changes from three months earlier (shown in Chart II) to smooth out some of the erratic monthly movements, has been dropping markedly since early this year under the influence of greater supplies of agricultural products. Similarly, there has been a substantial decline in the annual rate of price increases for the overall index since early this year. Increases in the cost of consumer services, although slower in July and August than in the first half of 1970, remained excessively high. Excluding food and services, prices of consumer commodities rose in annual terms at a seasonally adjusted 2.0 percent in August, the same rate as in July but the lowest for any month of 1970 except February.

In contrast to the slowing in consumer price increases, the pace of wholesale prices rose to a seasonally adjusted annual rate of 5.1 percent in September, following August's 1.0 percent decline. Agricultural prices largely accounted for these differences. While the consumer price index for food fell in August, wholesale agricultural prices surged ahead at more than a 15 percent annual rate in September, after having fallen at about a 5 percent rate in August. Much of this upward thrust came from higher prices for corn and other grains, linked to anticipations of short supplies because of the corn blight and adverse weather conditions. As a consequence of the September increase, prices for farm products returned to the level of this past April, wiping out all but a small portion of the improvement recorded this year. This raises the prospect that consumer prices for food could soon reflect these developments. However, industrial wholesale commodities prices rose in September by only 2 percent, the same relatively slow pace as in August. This is additional evidence of progress against inflation in an important part of the econ-

[2] The Bureau of Labor Statistics series on major collective bargaining agreements pertains to contracts covering 1,000 or more workers.

omy. Most of the slowing in industrial prices has been in manufactured goods, as fuel and power costs continue to be a source of upward pressure.

PERSONAL INCOME AND THE LABOR MARKET

July and August have been characterized by a marked improvement in the growth of personal income, compared with the second quarter of this year when there was little gain apart from the rise in Federal pay scales and social security benefits. Preliminary estimates for August indicate that personal income rose by $4.1 billion to a seasonally adjusted annual rate of $807.4 billion and, after a substantial upward revision, a $5.1 billion rise was recorded in July.

Larger wage and salary disbursements, mainly in the distributive, services, and government sectors, accounted for a major portion of the personal income gain during both July and August. Wages and salaries in manufacturing, which constitute roughly one fifth of overall personal income, were virtually unchanged in August, after relatively small gains in both June and July and decreases in four of the first five months of this year. These manufacturing data, unlike total personal income, do not reflect the direct impact of Federal pay and social security changes implemented earlier this year and, as such, are indicative of a basic lack of strength in an important sector of the economy.

Labor market weakness continued to be apparent in September, as unemployment rose and hours of work fell. Although seasonally adjusted nonagricultural employment was unchanged in September after five straight months of decline, downward revisions for both July and August reveal even more labor market slack than had been previously indicated. September employment gains in state and local government, trade, services, finance, and transportation and public utilities balanced cutbacks in construction and mining. Manufacturing employment, which had declined sharply since September of last year, was unchanged during September of this year. While hours of work in manufacturing fell to the lowest point since March 1961, a portion of this decline may stem from this year's inclusion of Labor Day in the survey week, thereby reducing the weekly payroll hours of those employees not paid for the holiday.

The September household survey indicated that the seasonally adjusted unemployment rate rose to 5.5 percent from August's 5.1 percent level. The jobless rate in September was the highest since January 1964 and stemmed from the combination of a large expansion in the labor force and unchanging employment. Patterns of unemployment for younger workers suggest that data for September and the preceding summer months may have been distorted by the difficulty of seasonal adjustment. Both the payroll and household surveys for September were conducted prior to the start of the strike at General Motors; should the dispute continue through mid-October, labor market data for that month may also be difficult to interpret. Each survey would be influenced in a different manner by the strike. For the household survey, strikers are counted as employed so that any increase in the unemployment rate associated with the dispute would have to come from its secondary effects, e.g., layoffs of employees working for nonstruck suppliers of parts and materials. Since neither strikers nor laid-off workers appear on company payrolls, nonagricultural employment as recorded in the payroll survey could be markedly depressed by the strike.

The Business Situation

Current business developments suggest a relatively sluggish recovery, but the underlying trend of the economy is obscured by the General Motors strike. Economic activity, as measured by the nation's real output of goods and services, registered a small advance in the third quarter, according to preliminary estimates. This was an improvement in the overall performance of the economy, compared with the previous three quarters. However, in the July-September period, unemployment climbed to 5.2 percent of the labor force, up from 4.8 percent in the previous quarter and 4.1 percent in the first quarter of 1970, while average hours worked continued to decline. Industrial production was down sharply in September, largely but not exclusively as the result of the automotive situation. August and September retail sales failed to sustain the momentum they seemed to be gathering in previous months, so that the increase in consumer spending over the whole quarter was only moderate. New orders for durable goods declined in September for the second consecutive month. Thus, with the exception of housing starts and building permits, which rose substantially during the third quarter, data for recent months give few indications of vigor.

While some tentative signs of moderation emerged on the price front during the third quarter, recent developments indicate that the persistent problems of inflation are still very much with us. During the third quarter, the price deflator for gross national product (GNP), which is the broadest measure of price changes in the economy, rose at about the same rate as in the second quarter but well below the rapid pace of the first quarter of the year. However, the consumer price index rose sharply in September. Much of the earlier slowing in consumer price increases had been linked to changes in food prices, a rather tenuous basis for improvement. The rate of price increases for wholesale industrial products, which are more central to the inflation problem than changes in agricultural prices, has zigzagged over the past year or so. This makes it difficult to attach much significance to quarterly or monthly changes, but wholesale prices of industrial commodities appeared to accelerate in September and, particularly, October.

Little or no evidence has appeared to indicate any ebbing in the rapidly rising tide of wage increases. Increases negotiated in contractual wage settlements continued to leap ahead during the third quarter, reaching a particularly dizzying pace in the unionized construction sector. Although rising productivity—largely resulting from substantial declines in man-hours associated with the business downturn—has blunted some of the impact of rising compensation on unit labor costs, wage and salary increases are far outstripping productivity gains. This can only serve to make the goal of reasonable price stability all the more difficult to attain.

GROSS NATIONAL PRODUCT

The market value of the nation's total output of goods and services rose $14.1 billion during the third quarter to an annual rate of $985.2 billion, according to preliminary estimates of the Department of Commerce. Since the impact of the General Motors strike was not felt until the latter half of September, it had only a limited effect on the figures for the entire quarter. Nevertheless, in the absence of the strike, the quarterly rise in GNP probably would have been $1 billion to $2 billion larger than the reported increase. Overall economic activity in the coming quarters will certainly be influenced by the length of the strike, the settlement terms, and the manner in which lost production is recouped. The longer the strike, the greater the secondary effects on suppliers of automotive materials and the greater the repercussions from reduced spending by those directly and indirectly idled as a result of the dispute.

Real GNP grew in the third quarter, but only at a very slow 1.4 percent annual rate. To be sure, there was an improvement over the previous three quarters when real output actually fell for six months and then remained about unchanged in the April-June period. Inflation accounted for the major part of the overall GNP advance. The price deflator for total GNP rose at an annual rate of 4.4 percent, which was about the same as the previous quarter's 4.3 percent gain but below the 6.4 percent rise in the first quarter.

The seasonally adjusted rate of increase in consumer prices slowed to about 4.2 percent during the July-September period. However, the consumer price index jumped ahead sharply in September to an annual rate of 6.4 percent, somewhat higher than the average over the preceding year and a half. The September rebound was most pronounced among prices of nonfood commodities and services, which are more indicative of basic inflationary pressures than are food prices, but the latter also rose on a seasonally adjusted basis.

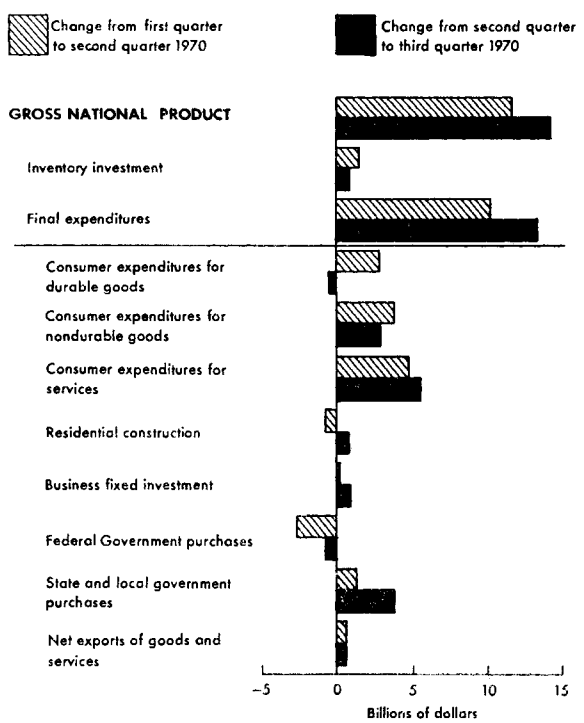
Recent movements in the wholesale price index have been dictated to a great extent by large, erratic swings in the prices of agricultural commodities. Since short-run movements in farm prices are heavily influenced by forces mainly outside the economic system, e.g., weather and blight, they are, in a sense, not at the core of the current inflationary problem. Prices of industrial wholesale products, on the other hand, are more responsive to changes in overall economic activity. Since monthly and quarterly rates of increase for wholesale industrial prices have a sawtooth appearance when mapped out over the past year or so, trends are difficult to discern. Nonetheless, the swift climb in the seasonally adjusted annual rate of increase from August's low 2 percent to September's 3 percent and, finally, to October's startling 7 percent rise is discouraging. On balance, the extent to which any price improvement can be discerned depends heavily on the indicators and time periods examined. At present, available evidence suggests that inflation remains a serious problem.

The somewhat stronger performance of total GNP in the third quarter was centered in final demand inasmuch as inventory spending remained modest. Both business fixed investment and residential construction were stepped up, the latter development bringing to an end the steady decline that had spanned the previous four quarters. State and local government spending also rebounded in response to improved credit market conditions (see Chart I).

Business spending on inventories contributed $0.9 billion to the third-quarter rise in GNP. While inventory spending imparted a somewhat larger ($1.5 billion) impetus to the growth of GNP during the second quarter of 1970, it had acted as a substantial drag in the two previous quarters. As usual, the preliminary inventory accumulation estimates for the third quarter are based on the developments during the first two months of the quarter. In making its estimate, however, the Commerce Department apparently adjusted for the likelihood that the large stockpiling of July and August in anticipation of the auto strike would not be repeated in September. During July and August, a large part of the advance in the book value of total business inventories took place at retail automotive outlets, leading to a sharp rise in the inventory-sales ratio for these stores. Based on preliminary data for July and August, however, there appears to have been a small decline in the third-quarter inventory-sales ratio for all businesses. No doubt, the automotive situation will continue to exert a considerable influence on inventory adjustments for some time to come.

Personal consumption expenditures rose $8 billion in the third quarter, the smallest gain since the final quarter of 1968. Spending on services was strong, but purchases of nondurable goods rose only slightly and expenditures for durable goods actually declined. These developments are consistent with the course of monthly retail sales, which began the quarter on a strong note in July but lost momentum during August and September. As a result, total third-quarter retail sales, using advance estimates for September, grew at a seasonally adjusted annual rate of only 2.7

Chart I
RECENT CHANGES IN GROSS NATIONAL PRODUCT AND ITS COMPONENTS
Seasonally adjusted



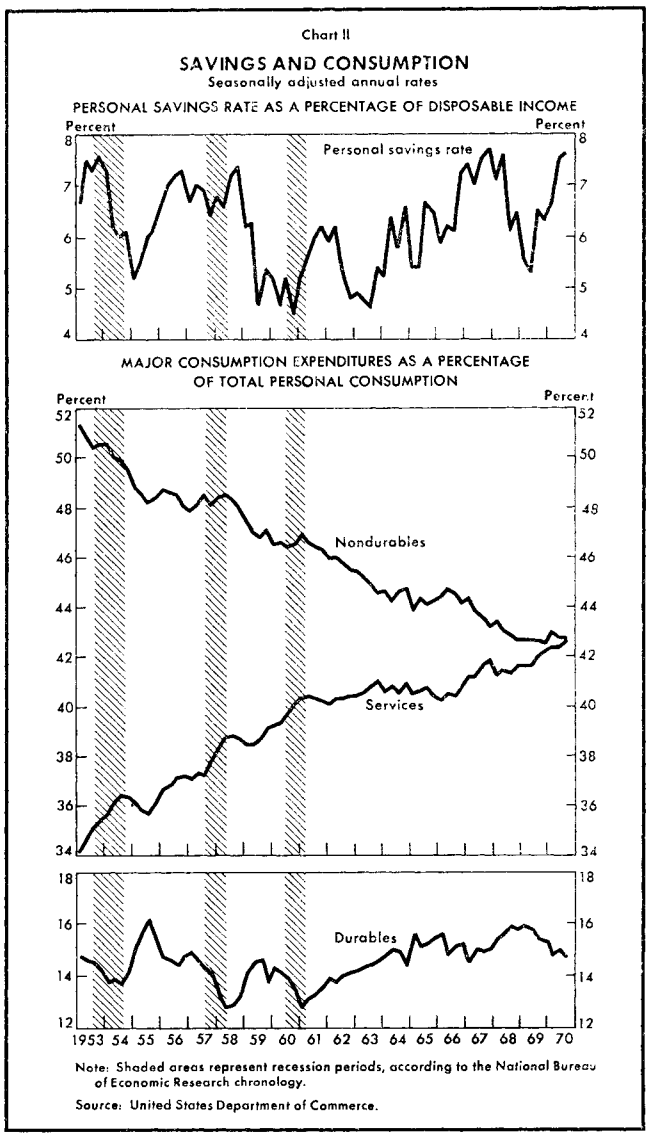
Source: United States Department of Commerce.

percent in contrast to the 10 percent rate of increase in the previous three months.

In the third quarter the growth of consumption spending was dampened both by the impact of a small increase in disposable, or after-tax, income and by an apparent preference on the part of consumers to save a greater than usual proportion of their incomes. Despite the expiration of the remaining 5 percent income tax surcharge, disposable incomes grew by the smallest amount since the first quarter of last year, as reduced man-hours and declines in payroll employment cut into wage and salary disbursements. The personal savings rate rose to 7.6 percent in the July-September period, which was quite high by historical standards (see Chart II). This unusually large volume of savings probably reflects consumer uncertainty over the outlook for prices and the economy. In addition, a part of the rise in the rate may be attributable to a normal lag in the adjustment of spending to the expiration of the income tax surcharge. The accumulated savings could provide fuel for a stronger pace of consumer spending in future months.

Spending on consumer services rose by $5.5 billion in line with the strong long-run growth trend of such consumption. Indeed, services have accounted for a larger and larger share of total consumer expenditures. Spending for services is currently 43 percent of consumption, compared with 35 percent in 1953 (see Chart II). All of this growth has been at the expense of nondurable goods, and the share accounted for by durable purchases—though varying over the business cycle—has been unchanged on balance. An important result of this shift is that more and more consumer outlays have been in areas where price increases have been the steepest. Productivity gains are particularly hard to achieve in the service industries, where consumer prices have risen at a 4 percent annual rate in the past decade, compared with a 2½ percent rate of increase in nondurable commodities.

After having declined a total of $5.5 billion since the second quarter of 1969, the dollar volume of residential construction rose by $0.7 billion during the third quarter —a rather modest but nonetheless encouraging increase. This pickup in the dollar volume of home-building activity was small by comparison with the upsurge in housing starts, which rose in the third quarter to the highest rate since the April-June period of last year. However, several factors seem to explain this difference. In terms of expenditures as recorded in the GNP accounts, a substantial part of the outlays associated with third-quarter housing starts will show up in subsequent quarters. In addition, there is some evidence suggesting that third-quarter construction was weighted more toward dwellings with lower value per unit, which partly reflected the fact that a somewhat higher proportion of multifamily structures was started than was the case in the preceding period. Also, the median selling price of new homes during the first two months of the third quarter was actually less than the selling price during the previous quarter and for all of 1969. It should be noted that, in addition to changes in selling prices of new homes having identical characteristics, variations over time in selling prices may also reflect shifts in geographic location and the proportion of homes of different size.



Business fixed investment added $0.9 billion to the third-quarter increase in GNP, according to the still preliminary estimate. Although on the weak side, this was somewhat ahead of the contribution made during the first half of the year. Spending on fixed investment has held up surprisingly well in the face of declining corporate profits and considerable excess capacity. By the third quarter of this year, the rate of manufacturing capacity utilization as measured by the Federal Reserve Board had fallen to 76 percent, the lowest since the first quarter of 1961. Output as a percentage of capacity has tended to decline fairly steadily since 1966 when it averaged 90.5 percent. Recent levels of new orders for producers' durable goods provide little evidence of current or impending buoyancy with respect to equipment spending. Were it not for the large September gain which appears primarily associated with increased shipbuilding bookings, third-quarter new orders for producers' durables would have been little changed from the first half of the year.

The total government sector contributed $2.9 billion to the third-quarter gain in GNP, with an increase in state and local government outlays more than offsetting a small net decline in Federal purchases. The latter reduction was associated with a cutback in defense spending which was only partly counterbalanced by a limited rise in nondefense purchases. Defense expenditures were off nearly 6 percent in the third quarter from the high reached in the third quarter of 1969. State and local government purchases of goods and services benefited from improved credit market conditions and grew by $3.7 billion.

PRODUCTION, PRODUCTIVITY, AND WAGES

The Federal Reserve Board's seasonally adjusted index of industrial production dropped 2.9 percentage points (1.7 percent) in September to a level nearly 5 percent below the July 1969 peak (see Chart III). About two thirds of the September decline was linked to the direct and indirect effects of the work stoppage at General Motors. Auto assemblies in September were at a seasonally adjusted annual rate of 5.7 million units, off fully one third from the previous month. The impact of the automotive dispute on the October index is likely to be in the range of 1 to 2 additional percentage points, but overall industrial production, of course, will also depend on output in sectors beyond the immediate influence of the strike.

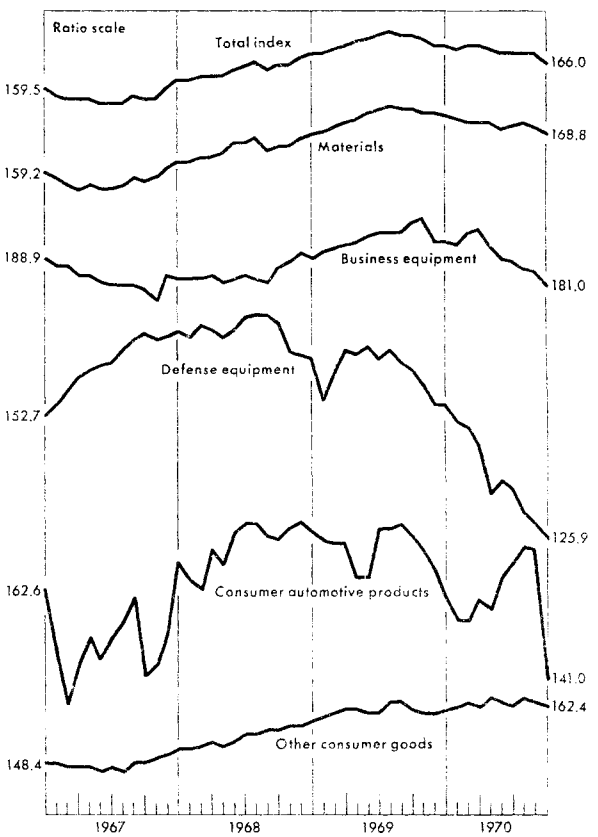
Among the major industry groupings, only mining, which benefited from a greater volume of fuel output, and utility production rose during September. Production by manufacturers of nondurables fell to the lowest level since January of last year. Equipment output continued the pronounced decline begun during October 1969, the result of further cutbacks in both the defense and business equipment sectors.

Compensation per man-hour in the total private economy rose at a swift 7.6 percent annual rate during the third quarter, the fastest this year. At the same time, the rather hectic pace of collective bargaining settlements showed few signs of abating. Over the first nine months of this year, the mean first-year wage and benefit settlement for collective bargaining agreements covering 5,000 or more workers was 14.7 percent, compared with the 10.9 percent rise over all of 1969. Mean increases for the full life of the contracts negotiated were 10.0 percent in the

Chart III

INDUSTRIAL PRODUCTION

Seasonally adjusted; 1957-59=100



Note: Indexes for defense equipment and nonautomotive consumer goods were calculated at the Federal Reserve Bank of New York from data published by the Board of Governors of the Federal Reserve System. Indexes are not plotted in rank order. Data for latest four months are subject to revision.

Source: Board of Governors of the Federal Reserve System.

first three quarters of this year as against 8.2 percent during all of last year.

Wage gains as a whole, and especially those in the unionized areas of the economy, have continued to outstrip productivity increases. Output per man-hour in the private economy, one measure of productivity, rose at a substantial 4.6 percent annual rate. This advance, however, was clearly associated with the business cycle since it stemmed from the combination of a small increase in output and a rather large decline in man-hours. These gains are distinct from those of a more permanent nature, resulting from such factors as innovation, increased use of capital, and a more educated labor force. Taken together, the output per man-hour and compensation movements indicated a third-quarter rise of 3.0 percent in labor costs per unit of output, perhaps giving some indication of pressures on price and cost levels. Although larger than the 1.5 percent increase in the preceding three months, this was a considerable improvement over the record of other quarters in 1969 and 1970. In these earlier intervals, the average advance in unit labor costs was well above a 7 percent annual rate while productivity gains were small and, in three of the five quarters, negative. In the manufacturing sector, compensation per man-hour rose at about the same rate as in the total private economy, but a much smaller rise in productivity led to a 6 percent increase in unit labor costs during the third quarter. On the whole, these third-quarter developments give little room for optimism. Unit labor costs were still rising at a rapid rate while compensation has continued, if not accelerated, its swift advance. This, coupled with the fact that productivity gains of the order of magnitude recorded in the period cannot be permanently maintained, tends to add a pessimistic note to the price-cost situation over the coming months.

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The Business Situation

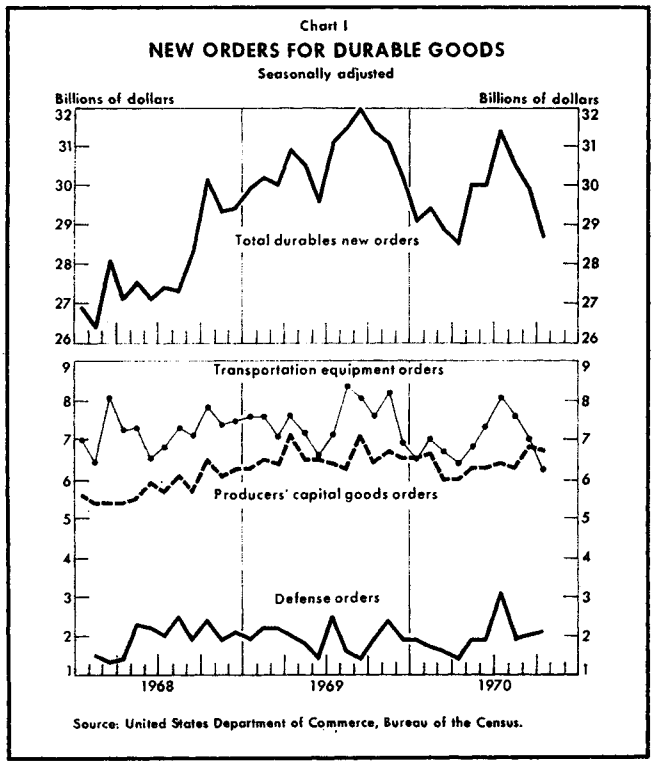
The pace of economic activity slackened noticeably in October and November. Industrial production, payroll employment, and personal income all posted substantial declines, and the unemployment rate edged upward to 5.8 percent. While the strike at the General Motors Corporation was the principal factor behind these developments, the available evidence suggests that the declines in output and employment were also widespread among industries other than those obviously affected by the strike. The latest surveys of plant and equipment spending plans for 1971 confirm the weak outlook that has been portrayed in other recent surveys of business capital spending—especially after allowing for the expected increases in capital goods prices. On a more optimistic note, corporate profits increased somewhat in the third quarter and activity in the residential construction sector has continued to show a strong upward thrust. Also, the settlement of the lengthy General Motors strike in late November should result in a substantial near-term stimulus for the economy, as that corporation strives to make up two months of lost production.

On the price-wage front, the performance of most key indicators remains very disappointing. In October, consumer prices rose at a substantial rate which matched the large September increase. Moreover, while wholesale prices of industrial commodities on a seasonally adjusted basis were unchanged in November, that development came on the heels of an extremely large October advance. Wages continue to rise at extraordinarily rapid rates, and newly negotiated contracts, including the agreement between General Motors and the United Automobile Workers, give little reason for optimism that a significant slowing of wage increases is imminent. Clearly, the realization of a reasonable degree of price stability will prove difficult against a background of wage hikes of the magnitude currently prevailing.

INDUSTRIAL PRODUCTION, ORDERS, SHIPMENTS, AND INVENTORIES

Partly as a result of the automotive strike, industrial production nose-dived during October, dropping 2.3 percent to 162.3 percent of its 1957-59 average. The Federal Reserve Board's index of industrial output is now 7 percent below the peak attained in July 1969. The October decline in production was centered in motor vehicles and parts, iron and steel, and business equipment. Only about one half of the month's decline in output can be attributed to the direct effects of the strike on automobile output and on the output of firms supplying the automobile industry. Defense-related production continued along its downward trend. Moreover, the index for business equipment dropped a substantial 1.7 percent to 178.0 percent of the 1957-59 average and is now 11.4 percent below the October 1969 level. The continuing decline in the output of business equipment reflects recent cutbacks in real spending for plant and equipment. Output of consumer durables also declined in October. As a result of the automobile strike, new passenger car assemblies plummeted in October by 29.0 percent following the 33.6 percent decline in September. Compared with automobile production in October 1969, output was down 53.0 percent. Output of other consumer durables in October was also off from the September level.

New orders for manufactured durable goods (see Chart I) dropped sharply in October by 3.9 percent to a seasonally adjusted level of $28.7 billion, marking the third successive monthly decline. In the last two months, however, the movements in this series have been centered in industries affected by the automobile strike, so that new orders for total durables are probably giving an overly bleak picture of the underlying orders situation. In the producers' capital goods sector, new orders slipped



slightly in October by 1.3 percent to a seasonally adjusted $6.7 billion, but only after posting a large 7.3 percent gain in September. For the third quarter as a whole, orders for capital goods increased 4.9 percent over the second quarter, reversing a downward trend that began in the third quarter of 1969. Sales of all durable goods manufacturers fell 4.8 percent in October to a seasonally adjusted level of $29.4 billion. Nevertheless, durables sales again exceeded new orders, as has been the case in nine of the first ten months in 1970. Thus, the backlog of unfilled orders for durables declined to a seasonally adjusted $78.8 billion, the lowest since September 1967.

Inventories of manufacturers swelled by $0.6 billion in October on a seasonally adjusted basis, well above the $0.3 billion average increase for earlier months this year. The accumulation of inventories was widespread among durables and nondurables industries. At the same time, there was a sharp decline of $1.5 billion in sales, of which more than two thirds occurred in the transportation equipment and primary metals industries. Thus, while the inventory-sales ratio for nondurables edged up only slightly, the ratio for the durables sector advanced to the highest level since 1958. However, since much of the decline in durables sales is strike related, it appears that this ratio somewhat overstates the problem of excess stocks. In September, the latest month for which complete data on trade inventories are available, the inventory accumulation of wholesalers and retailers outpaced sales and the inventory-sales ratio rose moderately.

CORPORATE PROFITS AND CASH FLOWS

Corporate profits before taxes, excluding the effects of price changes on the value of corporate inventories, grew by $1.5 billion to a seasonally adjusted annual rate of $79.0 billion in the third quarter.* This rise in profits followed a $0.8 billion increase in the second quarter. Despite these recent increments, however, pretax profits in the latest quarter were more than $8 billion below the early 1969 level. Profit margins—as measured by the ratio of after-tax corporate profits to gross product originating in nonfinancial corporations—rose slightly in the third quarter but remained low by historical standards.

To a large extent the modest advance in corporate profits in the third quarter stemmed from factors relating to the business cycle. Real corporate product increased, while employment and hours declined further, yielding a fairly large increase in productivity. Thus, although the pace of compensation per man-hour accelerated somewhat, the rate of advance in unit labor costs was low by recent standards. The growth in corporate profits suggests that price increases were more than large enough to offset the expansion in labor and other costs. As noted, however, in the third quarter, this configuration of events was associated with a sharp gain in productivity which far exceeded the normal long-run growth of real output per man-hour. In coming quarters, further gains in profits may depend on maintaining a better balance between rates of increase in compensation and in productivity. Given recent trends in wages and the possibly cyclical nature of the large productivity gains of the last two quarters, the near-term outlook for profits is by no means clear. The persistent cost pressures and the depressed ratio of profits to gross product suggest that business

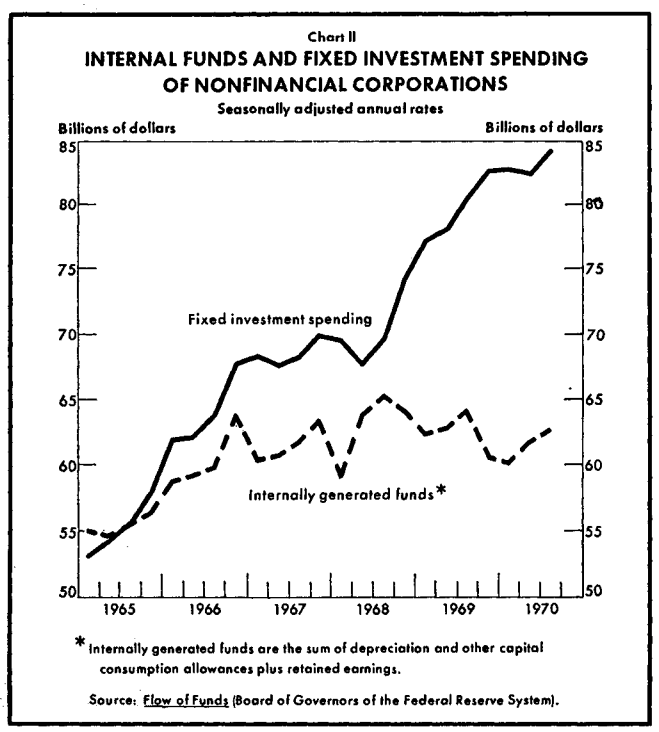
* The Commerce Department has revised its preliminary estimate of third-quarter gross national product (GNP) in current dollars upward by $0.3 billion to a seasonally adjusted annual rate of $985.5 billion. Also, the implicit price deflator for GNP was revised slightly upward by 0.07 percentage point. The revision in current-dollar GNP was the net result of a $1.5 billion addition to nonfarm business inventories and a $1.2 billion subtraction from "final expenditures", which was distributed fairly evenly among all categories.

may seek to maintain current profit positions by passing on the higher costs in the form of higher prices.

As a result of the depressed levels of corporate profits during the past year, the flow of internally generated corporate funds has fallen relative to the levels in 1969. This flow is the sum of corporate retained earnings, net of price-induced changes in the book-value of inventories, and capital consumption allowances. During the third quarter of 1970, the flow of internally generated funds into nonfinancial corporations was $1.4 billion less than the level prevailing in the same quarter of last year, though $1.1 billion higher than in the second quarter of 1970. As a consequence, funds acquired in the financial markets have become an increasingly important source of financing for plant and equipment spending (see Chart II). Thus, capital spending is likely to continue to be heavily influenced by developments in the money and bond markets which affect the cost and availability of external business financing.

CAPITAL SPENDING AND RESIDENTIAL CONSTRUCTION

Business spending plans for new plant and equipment have been scaled down substantially over the course of this year. According to the Commerce Department-Securities and Exchange Commission survey taken in the first quarter of 1970, businesses planned to step up their capital spending by about 10 percent during 1970. This planned percentage increase for the year was pared down in subsequent surveys, however, and the November survey indicates that plant and equipment spending in 1970 will rise by only 6.6 percent, a finding that confirmed the results of the previous August survey. Looking ahead to 1971, the latest Commerce-SEC survey calls for little change in capital spending during the first half of the year. This is consistent with the fall survey by McGraw-Hill, which indicated that businessmen plan to spend only 2 percent more on new plant and equipment in all of 1971 than in 1970. Since businessmen also reported that they are expecting a 7 percent rise in capital goods prices, present plans call for an outright cutback in physical investment in plant and equipment in 1971 relative to 1970. In the manufacturing sector alone, planned capital spending for the first half of 1971 is actually below current levels even in dollar terms, and this outlook seems to be consistent with the figures on capital appropriations by the nation's 1,000 largest manufacturers. While net new appropriations on a seasonally adjusted basis increased 8.3 percent in the third quarter, they remained 10.3 percent below those in the same quarter of 1969.



While capital spending plans for 1971 are still somewhat indefinite and subject to change, the incentives for capital spending certainly have been weakened by developments in 1970. According to the Federal Reserve Board's index of capacity utilization, manufacturers in the third quarter were operating at 76.2 percent of their estimated capacity, down 1.8 percentage points from the preceding quarter and down 8.0 percentage points from a year earlier. Production must grow at a rate faster than expansion in capacity for the rate of utilization to increase; unless utilization does increase, an important incentive for businesses' expanding their facilities will be lacking.

In contrast to many other areas of the economy, homebuilding activity continues to gather strength. In October, housing starts increased 3.1 percent over September to a seasonally adjusted annual rate of 1,550,000 units. During the third quarter, new housing units were begun at an annual rate of 1,511,000, which was 21 percent above the average for the first quarter and the highest rate since the second quarter of 1969. October's gain was in multifamily units, with single-family units dipping slightly. Accompanying October's increase in units begun was a hike in residential building permits. After increasing 3.4 percent in September, permits spurted again by 10.4 percent in October to a seasonally adjusted annual rate of 1,514,000 permits. Since permits have been generally pre-

ceded by mortgage commitments, it is only a question of time before these permits translate into actual starts.

EMPLOYMENT, INCOME, AND CONSUMER DEMAND

The labor market statistics for October and November are very difficult to interpret. On balance, however, these data provide little grounds for optimism. After nosing up slightly by 0.1 percentage point in October, the seasonally adjusted unemployment rate increased again in November by 0.2 percentage point to 5.8 percent. Since the household labor survey considers striking workers as employed, the unemployment rate in October and November was affected by the automotive strike only insofar as workers laid off by GM and related industries contributed to the rise in joblessness. The October-November rise in the unemployment rate centered in the adult women and teen-agers categories.

Payroll employment in October dropped by 315,000 to a seasonally adjusted 70,216,000, the lowest level since May 1969. Since striking workers are not receiving paychecks, these persons are not considered employed in the payroll survey. To some extent, the decline in payroll employment in October was the result of the automobile strike. Decreases in manufacturing jobs alone amounted to around 560,000 workers, of whom about 325,000 were striking auto workers. An undetermined, but probably quite substantial, proportion of the remaining 235,000 were workers laid off as a result of the strike. In November, payroll employment declined again. Since the automotive strike had not ended when the November survey was taken, the results for this month were also affected by the strike. Almost all the November decline in payroll employment centered in the manufacturing sector, presumably in part reflecting secondary strike-related layoffs. During October and November, average hours worked were essentially unchanged from their low September levels.

In October, personal income declined by $2.4 billion to a seasonally adjusted annual rate of $809.5 billion. Wage and salary disbursements were down fully $5.3 billion, largely reflecting the decrease in payroll employment. However, about $2 billion of this decline in wage and salary income was also due to the temporary boost given the September total by the nonrecurring payment to postal workers of the retroactive portion of their pay raise. In the private sector, the largest declines were in the transportation equipment and primary metals industries where the GM strike had its largest direct and indirect effects. The drop in total personal income was held to only about half of the fall in wage and salary income largely because of a gain of nearly $2 billion in transfer payments. The major factor in the latter increase was, however, a nonrecurring payment of retroactive benefits to retired railroad workers.

The automotive strike, which began in mid-September, had widespread effects on the economic aggregates for October. With respect to retail sales, the strike had a double-edged effect. Many potential buyers refrained from making any new car purchase, with the result that sales of domestically produced automobiles declined 13.3 percent in October. Consequently, the fall in durables retail sales swamped a modest 1.0 percent increase in nondurables retail sales. Moreover, the strike imposed a drastic loss of income on many workers, forcing them to tighten their belts. Now that a settlement has been negotiated, both these effects should unwind themselves with a resultant stimulus to retail sales. Overall, retail sales have been quite sluggish; during the first nine months of this year, they rose only 3.9 percent over the level of the corresponding period in 1969. This dollar gain fell short of the increase in prices over the same period, so that in terms of physical volume real retail sales actually fell.

Additional evidence of consumers' hesitancy is seen in the substantially reduced rates of increase in consumer credit outstanding. For the first ten months of 1970, the seasonally adjusted net increase in instalment credit, —that component of consumer credit most closely related to the purchases of goods—was down more than 50 percent from the similar period last year. The net change in instalment credit is the difference between new extensions and repayments on outstanding obligations, and all the decline resulted from a marked slowing in the rate of new extensions.

PRICE DEVELOPMENTS

The consumer price index rose at a seasonally adjusted annual rate of 6.4 percent in October, well above the average monthly increase of 5.4 percent for the first nine months of 1970 and even above the average monthly increase of 6.1 percent in 1969. Since food prices increased very slightly in October, the overall rise was attributable primarily to advances in prices of nonfood commodities and services. Nonfood commodities prices, adjusted for seasonal variation, rose at a rapid annual rate of 6.8 percent, primarily as a result of advances in new automobile and apparel prices. Prices of services rose at an annual rate of 6.1 percent in October, down considerably from the average monthly increase of 8.5 percent for the first nine months of 1970.

After increasing slightly in October, seasonally adjusted wholesale prices in November dipped back to the Septem-

ber level. However, this relative stability masks fairly substantial movements in the components of the total index. Wholesale agricultural prices plunged in October at an annual rate of 16.2 percent and, according to the preliminary estimate, declined an additional 5.1 percent in November. On the other hand, industrial commodities prices increased sharply in October at an annual rate of 7.5 percent, with extremely large gains being recorded for prices of fuels and transportation equipment. However, the preliminary November estimate indicates that wholesale prices of industrial commodities were unchanged. For the year ended November 1970, wholesale industrial prices have advanced 3.6 percent, compared with the 4.0 percent increase over the preceding twelve-month interval.

The Money and Bond Markets in November

Almost all interest rates fell steeply in November. Long-term rates moved lower after having been relatively flat during the preceding three months, while the downward trend in short-term rates gained considerable momentum. The broad-based decline in money market interest rates was fostered by slack demand for bank loans and short-term funds and the continuation of a moderately expansive monetary policy. Long-term rates fell as investors, convinced that interest rates were headed lower, bought fixed-income securities aggressively. As market rates plummeted, both the Federal Reserve discount rate and the commercial bank prime lending rate were reduced twice.

This pronounced decline in market interest rates, following their sharp rise in 1969 and early 1970, is to a large extent typical of the behavior of interest rates over the business cycle. Historically, interest rates have conformed positively to the business cycle—rising with expansions in business activity and falling with business contractions (see Chart I). In the postwar period, interest rates have tended to peak slightly before the peak in business activity, and both long- and short-term rates have usually reached their turning points at about the same time. The generally coincident movement in interest rates and the level of business activity reflects cyclical shifts in the demand and supply of loanable funds. In expansions, strong business demand for funds, prompted by the prospect of favorably high rates of return on physical investment, bids up interest rates. As the expansion progresses and a more restrictive monetary policy comes into play, the supply of loanable funds is constrained relative to continuing strong demand, and this contributes to the upswing in rates. On the other hand, in a period of economic sluggishness, the demand for funds weakens as investors become less willing to undertake capital expenditures in view of the uncertain outlook. The weaker demand, combined with an augmented supply of loanable funds resulting from a more expansive monetary policy, acts to bring rates down.

The behavior of interest rates in 1969-70 was somewhat different from the typical pattern in that rates peaked quite late in the cycle, and that the turning point in long-term rates occurred considerably after short-term rates had started to decline. A factor contributing to this behavior was the persistence of inflationary expectations. When investors anticipate that prices will rise, they demand a higher nominal rate of return to safeguard the purchasing power of their future stream of income. Since price increases in recent years had been sharp, expectations of continued strong inflation persisted, thus keeping nominal interest rates rising even after the downturn in business activity. An experience similar to this had occurred in 1957-58, the previous cycle in which the rate of inflation was relatively rapid.

In 1970 the rise in long-term rates continued even after short-term rates had begun trending downward. Since long-term rates are heavily influenced by expectations of rates in the future, this behavior may have been indicative of continued expectations of strong increases in prices and interest rates. Moreover, massive demands for funds in the capital market contributed to upward pressure on long-term rates. After peaking at midyear, long-term interest rates declined only moderately as an

FEDERAL RESERVE BANK OF NEW YORK

The Business Situation

Though obscured somewhat by the effects of the General Motors strike, recent business indicators suggest continued sluggishness in most sectors of the economy. In November, industrial production declined, personal income posted only a small increase, and retail sales continued to put on a lackluster performance. Continuing the trends which began in earlier months, businesses accumulated inventories at a relatively rapid pace while their sales generally fell; as a result, some areas of the economy —particularly the wholesale and manufacturing sectors— have a surfeit of inventory stocks. Although the automotive strike was partly responsible, the slackening in the economy seems to go beyond the direct and indirect effects of the work stoppage. In sharp contrast to much of the rest of the economy, residential construction activity has continued to gain upward momentum. With the resumption of production at GM, the stepped-up activity in the automobile and related industries should provide a substantial impetus to production and employment in the months immediately ahead.

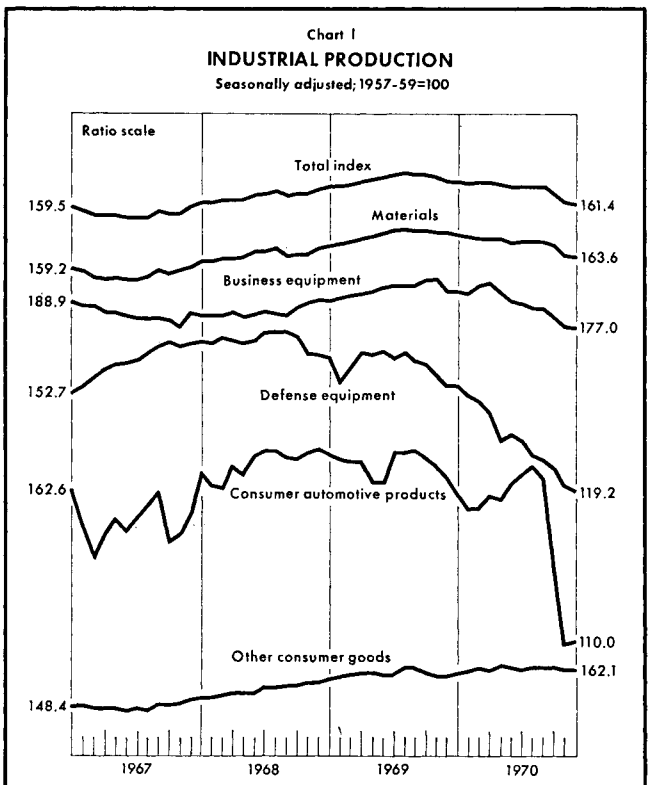
Despite the pervasive slack within the economy, consumer prices have continued their steep ascent. There has been some moderation in the rate of advance of the overall consumer price index as a result of a marked slowing in the pace of food price increases. However, this development has obscured somewhat the extremely rapid rise in prices of nonfood consumer commodities and consumer services. At the same time, the rate of advance of wholesale industrial prices does appear to have moderated somewhat during 1970, affording some encouragement that prices of consumer nonfood commodities may soon respond similarly. Thus far, however, there have not been any clear signs of abatement in the rate of consumer price increases.

PRODUCTION, ORDERS, AND INVENTORIES

Industrial production continued its downtrend in November, contracting by 0.6 percent on a seasonally adjusted basis (see Chart I). Unlike the preceding two months when the fall in production was partially attributable to the strike at GM, the indirect effects of this work stoppage appear to have added little downward impetus to the overall index. The November drop centered in the business and defense equipment and the materials components. At its November level of 161.4 percent of the 1957-59 base, the Federal Reserve Board's index of industrial production was 7.6 percent below the peak attained in July 1969. Thus, measured in terms of this index, the current business slowdown is comparable in magnitude to the 7.3 percent fall during the 1960-61 contraction but is considerably milder than the 14 percent decline recorded in the 1957-58 recession. With the resumption of production at GM in late November, the index will probably show considerable gains in the near term as the effects of the ten-week strike unwind themselves.

Output of consumer goods was virtually unchanged despite the fact that the production of automobiles actually edged upward. Consumer goods output exclusive of automobiles was sluggish throughout the year; for the first eleven months of 1970 the index has risen by only 0.9 percent. Moreover, among selected consumer goods categories, such as furniture and apparel, output actually decreased in 1970. The November declines in defense and business equipment output were further extensions of downward trends which have been under way for some time. Defense goods production has been on the downslide since August 1968, while business equipment production has declined 11.9 percent from the October 1969 peak.

Following three consecutive—and at least partly strike-related—monthly declines, new orders for durable goods advanced by 1.9 percent in November on a seasonally adjusted basis. However, at $29.0 billion, orders in November were still 5.2 percent below the monthly average in 1969. The principal factors underlying the November increase in durables orders were the sharp spurts in orders for nonautomotive consumer durables and producers' capital goods. Having jumped 5.8 percent to $6.9 billion, orders for producers' capital goods reached the highest level since September 1969. Capital goods orders appear to have strengthened somewhat in the last three months, although the monthly average for the first eleven months of 1970 was still below the average for 1969. In view of the general lack of growth in planned plant and



Note: Indexes for defense equipment and nonautomotive consumer goods were calculated at the Federal Reserve Bank of New York from data published by the Board of Governors of the Federal Reserve System. Indexes are not plotted in rank order. Data for latest four months are subject to revision.

Source: Board of Governors of the Federal Reserve System.

equipment expenditures projected by recent surveys, it is uncertain whether this uptrend in orders is indicative of some future strengthening in investment spending. While orders for durables increased in November, durables shipments continued to edge down to the lowest level since December 1968, marking the fourth successive monthly decline.

There apparently continue to be some areas in the economy where inventory stocks are a bit high relative to the volume of sales, though the extent of the imbalances has been clouded by the automotive strike. Large accumulations of inventories in October at wholesale outlets, retail stores, and manufacturing firms more than offset a $1.0 billion contraction of retail automobile dealers' stocks, so that total business inventories rose by only a small amount. Within the trade category, the inventory-sales ratio for nonautomotive retailers actually dipped slightly. At wholesale outlets, however, accumulations of stocks continued to outrun sales, and the inventory-sales ratio rose to its highest level in a decade. Manufacturers' inventories swelled by $0.8 billion in October, more than double the average increase in earlier months of 1970. This inventory accumulation coupled with a $1.5 billion fall in sales pushed up the inventory-sales ratio, with the imbalance problem concentrated in the durables sector. Because much of the October decline in durables sales was strike related, it appears that the inventory-sales ratio for durables manufacturing somewhat overstates the extent of any inventory-imbalance problem in this sector. However, November data—which are available for manufacturing only—indicate that the problem of excess stocks in the manufacturing sector was exacerbated in that month. Durables manufacturers accumulated another $0.4 billion of inventories in November, while their sales dropped by $0.6 billion. Unlike that in the previous month, the November fall in sales was widely distributed and was not primarily associated with the automotive strike. Indeed, even the large decline in the sales of transportation equipment was accounted for by reductions in the shipments of the aerospace industry.

RESIDENTIAL AND NONRESIDENTIAL CONSTRUCTION ACTIVITY

After having bottomed out in the first quarter, residential construction activity has progressively strengthened throughout the third quarter. This trend continued in November when total private housing starts expanded by 122,000 units to a seasonally adjusted annual rate of about 1.7 million units. This represented the largest number of starts initiated in any one month since January 1969 and exceeded the average number of starts recorded in the first quarter of 1970 by 35 percent. About 60 percent of the November surge in starts occurred in the multifamily category. However, starts of single-family structures, which typically have a higher value per unit, also rose by about 50,000 in November to the highest level since December 1968. Because construction activity is spread out for several months after new units are begun, residential housing expenditures tend to lag the series on housing starts. Thus, following the trend in housing starts, outlays for nonfarm residential buildings have also accelerated sharply in recent months. Since June, when outlays fell to a recent low of $28.1 billion on a seasonally adjusted annual rate basis, spending on housing has expanded at an annual rate of 20.4 percent through November. Moreover, the November surge in starts would suggest some further gains in outlays in the months immediately ahead. In a similar vein, the recent strength in

building permits also suggests some further strength in this sector. Marking the fourth consecutive monthly increase, new permits advanced slightly in November to a record high 126.0 percent of the 1957-59 base.

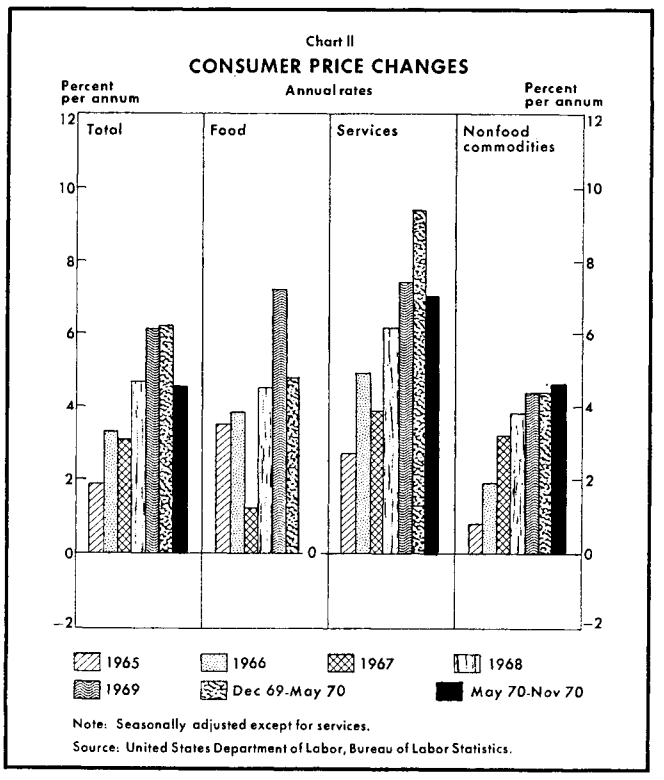
Residential construction activity continues to be favorably influenced by the large deposit flows to the nation's mutual savings banks and savings and loan associations, the major suppliers of mortgage credit. While these flows have, of course, expanded the availability of mortgage credit, there is some evidence that the increased supply of funds is beginning to produce some easing in the terms under which mortgages are granted. Mortgage interest rates, which tend to be quite sticky, have edged down slightly. Between July and October, the interest rate on thirty-year Federal Housing Administration mortgages fell by 14 basis points and that on conventional mortgages declined by 10 basis points. The latest data show an increase in the loan-price ratio for conventional mortgages on new homes, suggesting a reduction in down-payment requirements. This easing in mortgage market conditions bodes well for an extension of the strength in residential construction activity into 1971.

While construction activity in the residential sector has gained upward momentum throughout most of 1970, the opposite trend has emerged in the private nonresidential construction sector. Indeed, for the three months ended in November, the value of new commercial and industrial construction put in place was 10.6 percent below the first-quarter annual rate average of $17.6 billion. Similarly, the F. W. Dodge data on construction contract awards for commercial and industrial structures have been characterized by a distinct downward trend in 1970, and spending on nonresidential structures as measured in the gross national product (GNP) accounts showed absolute declines in both the second and third quarters of 1970. The weakness of new construction activity in the industrial and commercial sector is, of course, in line with the paring-down in business planned capital spending which has characterized 1970. In real terms, outlays on structures have fallen off more sharply than have outlays on producers' capital equipment. This suggests that business firms have attempted to economize on their investment costs by expanding and modernizing productive facilities within existing structures.

PRICE DEVELOPMENTS

Inflation continues to be a more deeply rooted problem than most observers had originally thought; despite the slowdown in economic activity, the pace of inflation does not appear to have noticeably abated. In November, the consumer price index advanced at a seasonally adjusted annual rate of 3.7 percent, down considerably from the 6.4 percent average increase of the preceding two months. In view of the seesaw monthly movements in the rates of change in this index throughout the year, it is too soon to hail November's slowdown as the beginning of a downtrend. Moreover, part of the improvement in November was the result of the decline in food prices, whereas the rise in nonfood commodities prices actually exceeded the average gain in these prices for the first half of 1970.

During the past two years, the price rises originating in various sectors have contributed disproportionately to the gains in the overall consumer price index (see Chart II). While in 1969 rising food prices pulled up the overall index, they have tended to dampen the advances in the consumer price index during 1970, particularly in the closing months of the year. On the other hand, nonfood commodities prices continue to surge ahead. Adjusted for seasonal variation, these prices increased 4.8 percent in November, following rises of 6.8 percent in October and 6.8 percent in September. As shown in Chart II, there has been no abatement in the rate at which nonfood



commodities prices have been advancing. The failure of these prices to respond to the economic slowdown is one of the most perplexing aspects of the present inflation. Similarly, services prices accelerated in November, growing at a rate of 7.6 percent. (Services include such things as medical care, various modes of public transportation, and insurance.) Price rises in this sector have been the primary source of increases in the consumer price index. Though constituting only about one fourth of the overall index, services prices have contributed a shade more than half the past year's rise. Like those for nonfood commodities, these price rises have also stubbornly persisted.

There has lately been some easing in the rate at which wholesale industrial prices have been advancing. In December, according to preliminary seasonally adjusted estimates, these prices rose at an annual rate of 2.8 percent, reflecting primarily the higher prices of fuels and electrical power. During the second half of 1970, industrial wholesale prices posted a 3.2 percent annual rate gain, compared with the 3.8 percent growth in the first half of 1970 and the 4.2 percent growth in the second half of 1969. It may be that the failure of consumer commodities prices to reflect the slowing in the pace of wholesale industrial prices is in part a consequence of the rapidly rising shipping costs. Wholesale agricultural prices fell 7.2 percent on a seasonally adjusted annual rate basis in December, marking the third successive monthly decline. This decline entirely offset the advance in industrial commodities prices so that the seasonally adjusted overall wholesale price index was unchanged in December.

PERSONAL INCOME AND CONSUMER DEMAND

Personal income posted a relatively small increase of $2.4 billion in November, less than half the average monthly increase registered in 1969. This gain was depressed somewhat by a roughly $1 billion nonrecurring payment to retired railroad workers in October, which had buoyed the level of personal income in that month, while the removal of the retroactive payment from the November data depressed the level of personal income in that month. Even allowing for this factor, however, the rise in personal income in November was of a relatively small magnitude. The growth in personal income principally reflected a $1.8 billion gain in wage and salary disbursements; in turn, this increase in disbursements centered in the government and services sectors which posted expansions in payroll employment in November. In the manufacturing sector, wage and salary disbursements declined slightly, mirroring the November contractions in overtime hours and employment.

According to preliminary estimates, there was a small decline during November in durables retail sales which more than offset the gain in nondurables sales, so that total retail sales on a seasonally adjusted basis edged down 0.5 percent. While consumer spending has been sluggish all year, the purchases of durable goods have been particularly lethargic. Dealer sales of domestically produced new cars during the first eight months of the year were off 8.2 percent from the corresponding average for the last year; during the September-November period when the GM strike was in effect, dealer sales of new cars produced by the other automotive companies contracted further on a seasonally adjusted basis. In addition, retail sales of nonautomotive durables have failed to register any growth during the year; for the first ten months, nonautomotive durables sales in current dollars were virtually unchanged relative to the same period in 1969. Concurrent with the sluggishness in retail sales—and in consumer demand generally—have been large increases in disposable income, which is equal roughly to personal income less personal taxes. As a result, then, the personal savings rate has been abnormally high all year. The large store of savings accumulated in recent quarters may provide the fuel for future step-up in the pace of consumer spending, though its timing and magnitude are still uncertain.

The Business Situation

The nation's output of goods and services declined substantially during the fourth quarter of 1970, when the automotive strike was superimposed upon an already slack economy. Inasmuch as the strike affected almost every individual component of the gross national product (GNP) accounts, it is difficult to measure the full impact of the work stoppage on GNP. Continuing a pattern which has been uninterrupted since last July, the unemployment rate rose throughout the fourth quarter, reaching the 6.2 percent mark in the final month of 1970. Although industrial production increased in December for the first time since July, virtually all the rise was related to the start-up of production at General Motors. Only spending on residential housing showed any significant advance. Whether the buoyancy in this sector will extend to others and generate an overall economic recovery depends primarily on whether there is a resurgence of consumer spending.

Despite the slowdown in business activity in the fourth quarter, the implicit price deflator for GNP rose sharply. While much of the acceleration in this indicator stemmed from technical factors associated with the automotive strike, the underlying price situation showed no apparent improvement over the rapid rate of inflation that had characterized the earlier part of 1970. Indeed, the rate of increase in consumer prices accelerated in the fourth quarter, with all components of the consumer price index (CPI) participating in this step-up. The acceleration in the price advance of nonfood commodities, which exceeded that of the other components of the CPI, was bitterly disappointing since these prices are usually the ones most sensitive to general demand conditions. At the same time, there was some slowdown in the rise of compensation per man-hour; nevertheless, the even greater fall in the growth of output per man-hour, largely the result of the GM strike, resulted in a strong advance in unit labor costs.

GROSS NATIONAL PRODUCT

The market value of the nation's total output of goods and services edged up $5.4 billion during the fourth quarter of 1970 (see Chart I) to a seasonally adjusted annual rate of $990.9 billion, according to the Department of Commerce's preliminary estimate. This increase was less than half the average rise in GNP in the preceding three quarters and was the smallest quarterly increment since the first quarter of 1967. The depressing influence of the automotive strike on the economy was sizable though difficult to quantify precisely. After allowing for the effects of inflation, the output of real goods and services fell at an annual rate of 3.3 percent in the fourth quarter. This decline, coupled with that in the first quarter, more than offset the small gains in real GNP in the interim quarters. Thus, for the year as a whole, real output fell below the production level recorded in 1969; not since 1957 had there been a year-to-year drop in real GNP.

The rate of increase of final expenditures—GNP less inventory investment—abated in the final quarter of 1970. The increase in final spending was barely half that of the previous quarter. Underlying this slowdown were outright cutbacks in consumption spending on durable goods, in business fixed investment, and in defense spending by the Federal Government. These reductions, however, were more than offset by increases in consumer spending on nondurable goods and services, in residential housing expenditures, and in state and local government spending.

Businesses' inventory investment acted as a drag on the expansion of GNP in the fourth quarter. According to preliminary estimates based mainly on data for the first two months of the quarter, the annual rate of accumulation of inventories fell by $1.4 billion to $4.1 billion, following slight accelerations in the preceding two quarters. This slowdown primarily reflects the activities of retail automobile dealers who continued to sell automotive products after the strike had begun. Elsewhere in the economy, particularly at the wholesale trade outlets and durables manufacturing firms, the pace of inventory accumulation quickened in October and November. At the same time, manufacturers' sales declined, with most of the decrease centered among durables producers, so that it appeared that inventory stocks were somewhat in excess of requirements. The increases in the inventory-sales ratios for the durables and nondurables manufacturing sectors were reversed in December, owing to a slight

decumulation of inventories and an increase in sales in both sectors.

The growth in personal consumption expenditures dropped rather sharply in the fourth quarter. This slowing reflected the reduction in spending on durables, while outlays on nondurable consumer goods and services accelerated slightly. The 6.4 percent decline in spending on durable goods in the fourth quarter was the largest such decrease since 1951. All of the decline centered in the automotive component of durables spending, as the strike-related effects reinforced an apparently underlying weakness in automotive demand. Outlays on consumer nondurables and services in the fourth quarter increased by $11.3 billion. Looking at the year as a whole, consumer spending exclusive of durables expenditures increased slightly more than in the previous year, while durables spending posted a substantial decline, only part of which was attributable to the GM strike.

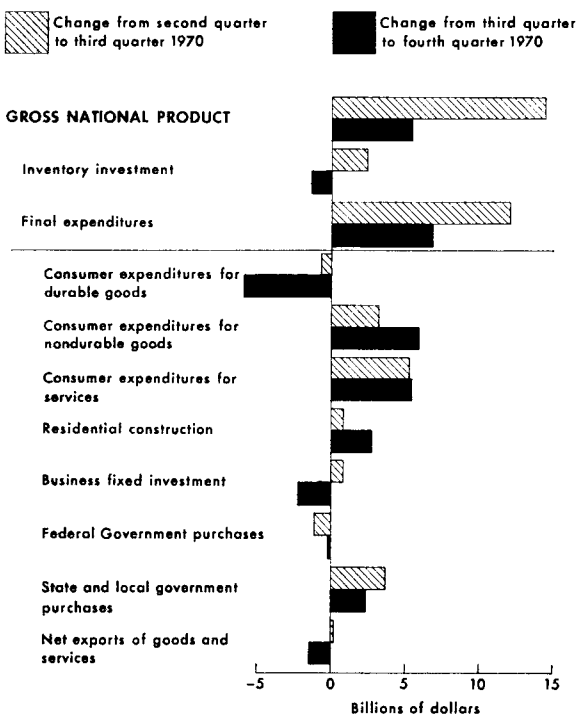
Although consumer spending slowed, it outpaced the very small $3.9 billion rise in disposable income in the fourth quarter of 1970. As a result, the personal savings rate dipped 0.3 percentage point to a still high level of 7.3 percent. During the last three quarters of 1970, the savings rate averaged 7.5 percent. This prolonged period of very high levels of personal saving is most unusual by historical standards. Whether or not the savings rate will move downward this year is one of the key factors which will determine the pace of overall economic activity over the course of the year.

Spending on residential structures expanded by a substantial $2.8 billion in the fourth quarter, the largest increase since the third quarter of 1967. This increase followed declines in the first two quarters and a small rise in the third quarter of 1970. The upward trend in spending on residential construction gives promise of extending for several months to come, according to advance indicators. For example, in the closing month of 1970, the rate at which new housing units were begun surged 18 percent and building permits issued by local authorities jumped 17 percent.

Because work progresses on a new housing structure for some time after the unit is begun, the expenditures series lags the housing starts series. Housing starts fell in the first quarter of 1970 to the lowest level since the second quarter of 1967 and have risen in each subsequent quarter, so that fourth-quarter seasonally adjusted starts were on the average 40 percent above those in the beginning quarter. Both single-family and multifamily structures have participated in this recovery, though single-family units expanded at a somewhat faster rate. Following the movement in the starts series, residential expenditures bottomed out in the second quarter and have gained momentum since then; in the fourth quarter, expenditures were 13 percent higher than those in the second. The sharply increased activity in this sector stems from the increased availability of mortgage financing as well as from the swelling of Federal housing subsidy programs. Large inflows of funds into savings institutions—the result, in part, of the high personal savings rate and declines in market interest rates which have improved the competitive position of thrift institutions—have led to some easing in the terms under which new mortgages are extended. Indicative of this trend were the December and January reductions in Federal Housing Administration-insured and Veterans Administration-guaranteed rates and the January lowering of conventional mortgage interest rates by some large New York City commercial banks.

After increasing slightly in the preceding two quarters, business fixed investment fell in the fourth quarter, the result of reduced spending on both structures and pro-

Chart I
RECENT CHANGES IN GROSS NATIONAL PRODUCT AND ITS COMPONENTS
Seasonally adjusted



Source: United States Department of Commerce.

ducers' durable equipment. The slight fall in expenditures on new business structures marks the third successive quarterly decline. Since trucks and fleet automobiles are an important component of businesses' equipment expenditures, the decline in equipment spending was due mostly to the GM strike. Thus, the resumption of production at GM is likely to boost this component of capital spending somewhat in the current quarter. Apart from the strike, however, business fixed investment spending appears to have leveled off. Separate surveys by McGraw-Hill and by the Commerce Department and Securities and Exchange Commission indicate that firms are planning to increase their plant and equipment expenditures in 1971 by a modest 1 to 2 percent; moreover, all of this increase is scheduled by nonmanufacturing firms, while manufacturers reported that they were planning a cutback in capital spending. This projected weakness reflects, among other things, the depressed level of corporate profits, sluggish sales, and the increasingly large proportion of unused capacity. After these surveys were taken, the Treasury announced its intention to ease the rules by which businesses may depreciate their capital equipment. Nevertheless, it seems unlikely that this move will spur producers' durable equipment spending significantly unless there are concurrent improvements in underlying business conditions.

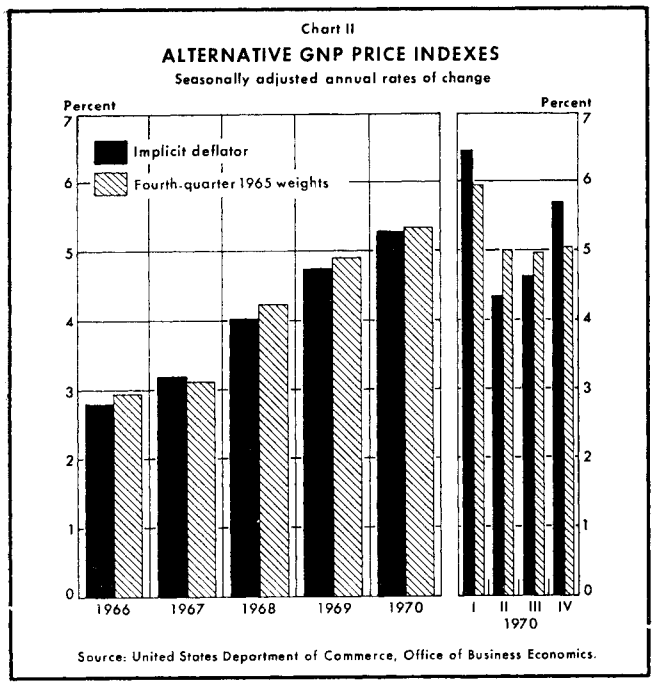
Increased spending by state and local governments contributed $2.4 billion to the small gain in current-dollar GNP in the fourth quarter. This was somewhat below the rise in state and local government expenditures in the previous quarter. Taking the two quarters together, however, such spending rose at a faster rate than in any half year since the first half of 1968. This acceleration was to some extent related to the marked easing in credit market conditions which characterized the last six months of 1970. Federal Government expenditures, on the other hand, declined slightly in the final quarter of 1970, as a result of a further decrease in defense spending. This more than offset a resurgence in nondefense outlays which followed a net decrease in such spending over the three previous quarters.

PRICE DEVELOPMENTS

All of the increase in current-dollar GNP in the final quarter of 1970 stemmed from rising prices. The rate of increase of the implicit price deflator for total GNP accelerated to 5.7 percent in the fourth quarter, up considerably from the 4.5 percent average rise in the previous two quarters. Much of this acceleration resulted from the compositional shift in output associated with the strike. The implicit deflator is a weighted average of price indexes for all goods and services; the weight attached to a particular good or service is equal to the proportion of total expenditures in real terms (1958 dollars) that is spent on it in the current quarter. Since 1958, automotive prices have risen less than prices of other goods, so that the price index for autos is low relative to the price indexes for other goods and services. With the output and consumption of automotive goods depressed in the fourth quarter, the composition of output was concentrated in goods with higher price indexes. Even if all prices had remained constant in the fourth quarter, this compositional shift would still have caused the deflator to rise.

The importance of such compositional shifts in the "output mix" as a source of changes in the implicit deflator is not limited to the latest quarter. As an alternative price index, one which abstracts from compositional shifts, the weights used in computing the GNP deflator could be set equal to their value in a particular period—say, the fourth quarter of 1965—and not allowed to change. Any variations in this alternative constant-weight price index (to which class belong the consumer and wholesale price indexes) solely reflect price changes. A comparison of movements of this constant-weight price index with the implicit price deflator (see Chart II) provides a rough guide as to the importance of compositional shifts in inducing changes in the implicit deflator. While the two indexes have moved on a yearly basis along broadly similar lines, their quarterly rates of acceleration or deceleration have differed. In the fourth quarter, this constant-weight price index for total GNP rose at an annual rate of 5.0 percent, only slightly higher than the 4.9 percent average increase for the previous two quarters. Thus, as technical factors were largely responsible for the acceleration in the GNP deflator, it appears that the underlying price situation was essentially unchanged in the fourth quarter. Inflation still gave no clear sign of having yielded to the economic slowdown.

Consumer prices in December rose 6.4 percent on a seasonally adjusted annual rate basis, considerably above the 3.7 percent November advance. As the rate of increase in prices of services declined somewhat, all the December acceleration in the overall index stemmed from rising commodities prices. After falling slightly in November, food prices posted a 2.7 percent rise in December, thus contributing partly to the speedup in consumer prices. The rate of increase in nonfood consumer prices also accelerated in December to 6.7 percent, well above the 4.6 percent average monthly increase for the year ended in November. During the fourth quarter, consumer prices



increased at a faster rate. While prices of services and food both contributed to this development, most of the quarterly acceleration stemmed from nonfood commodities prices which increased 5.8 percent in the fourth quarter, compared with the 3.9 percent growth in the previous quarter. At the wholesale level, prices increased 4.6 percent on a seasonally adjusted annual rate basis in January, after remaining unchanged in December. A sharp jump in wholesale agricultural prices entirely accounted for the January acceleration, while the rate of increase in wholesale industrial prices dropped from 4.0 percent in December to 1.7 percent in January.

PRODUCTION AND EMPLOYMENT

Following the resumption of production at GM, the Federal Reserve Board's index of industrial output climbed 1.4 percent on a seasonally adjusted basis to 163.9 percent of the 1957-59 average. Apart from the increased automotive production, it appears that the pace of the economy was little changed from the preceding month; industrial output less the automotive component nosed up only 0.1 percent and was 5.5 percent below the peak attained in July 1969. Output of motor vehicles and parts jumped 45 percent but failed to reach the pre-strike level. For the most part, this reflected the slow production start-up at GM, but production and sales of automobiles by GM's competitors were decidedly sluggish at the close of the year, leading to some employment layoffs.

The surge in automotive production was reflected in varying degrees in all the market grouping indexes. Within the consumer goods category, a decline in the production of appliances was offset by a rise in that of consumer staples, so that the index for nonautomotive consumer goods was unchanged. Thus, the 2.4 percent rise in the overall consumer goods index was attributable wholly to the automotive component. Reflecting the increase in truck production, the index for defense and business equipment edged up, while declines were registered in the production of industrial equipment, defense goods, and commercial aircraft. Finally, the materials index advanced, the result in part of increased iron and steel output stemming from the automotive start-up.

Concurrent with the fourth-quarter decline in real output, labor market conditions eased noticeably. While part of this deterioration was associated with the GM strike, the December data suggest that the easing went beyond the direct and indirect effects of the strike. In December, the unemployment rate rose 0.3 percentage point to 6.2 percent despite the resumption of production at GM. This latest rise in joblessness brought the average unemployment rate for the quarter to 5.9 percent, well above the third-quarter average of 5.2 percent and dramatically above the 3.7 percent level that prevailed in the fourth quarter of 1969. In January, the unemployment rate fell slightly to 6.0 percent.

The data for nonagricultural payroll employment also reflect some slippage during December. About 180,000 workers were added to the payrolls of nonagricultural firms. This gain was more than accounted for by the 276,000 increase in manufacturing jobs, which reflected the return to work of most of the 350,000 striking automotive workers. Nevertheless, at its December level of 18.8 million workers, manufacturing employment was still 460,000 below the August pre-strike level and was more than 1 million below the December 1969 level. Similarly, total nonagricultural employment in December 1970 failed to return to its pre-strike level and was about 600,000 below the December 1969 level. In January, total nonagricultural employment posted an increase of about 200,000, which was centered in the services and trade sectors while manufacturing employment was virtually unchanged.

The Business Situation

In the opening months of 1971 many business indicators have moved upward, as stepped-up activity in the automobile industry was reflected in higher levels of production, income, orders, and sales. However, since much —but not all—of these gains in economic activity are strike related, there has as yet been little evidence of a significant underlying strengthening in the economy. In fact, in January, industrial production and manufacturing payroll employment were below the levels that had prevailed at the outset of the General Motors strike. In part, this is a reflection of the relatively slow pace at which automobile production has been resumed after the work stoppage. While interpretation of recent inventory data is complicated by the strike and its aftermath, the most recent information suggests that stocks in some sectors are a bit on the high side in relation to sales quite apart from any strike-induced distortions. The likelihood of substantial stockpiling of steel mill products in anticipation of a midsummer steel strike will probably push inventories higher in the coming months.

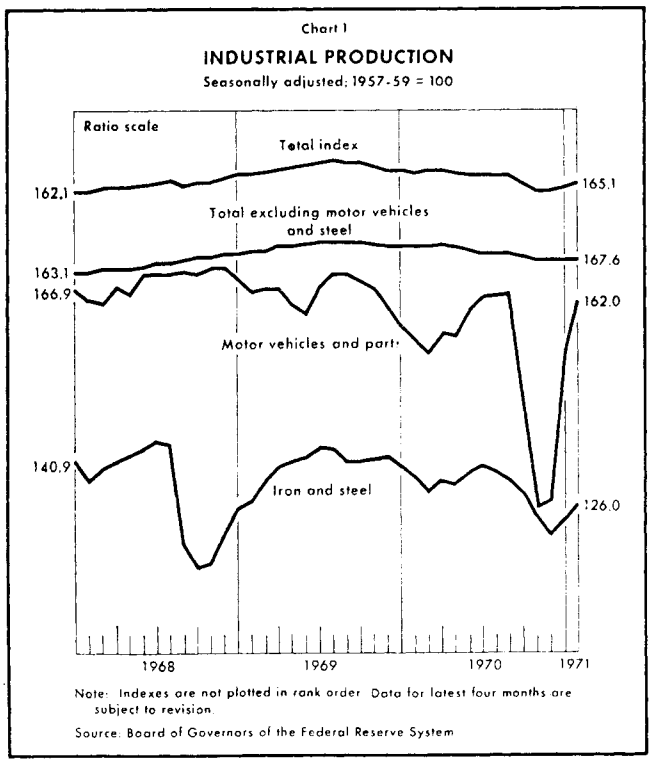
The behavior of wages continues to be inflationary. During the fourth quarter of 1970 and for the year as a whole, compensation per man-hour in the private economy rose at a rate only a trifle below the rapid expansion experienced in the preceding year. The value of newly negotiated wage settlements continues to surge ahead at an essentially unabated rate, providing wage increases far in excess of any conceivable long-run gains in productivity. Moreover, the magnitude of the wage gains embodied in these contracts may be understated, since the contracts frequently provide cost-of-living adjustments which are not fully reflected in the reported data. Recent price developments have been somewhat mixed, in part because of volatile movements in the agricultural and food components of both the consumer and wholesale price indexes. However, in January the rate of increase in nonfood commodity prices moderated at the consumer level, and preliminary data for February suggest a slowing of wholesale industrial prices. While both of these developments are encouraging, one- or two-month slowdowns in these price indexes have materialized in the past only to be quickly reversed.

PRODUCTION, SHIPMENTS, AND INVENTORIES

The Federal Reserve Board's index of industrial production increased in January for the second consecutive month. The index rose by 0.7 percent on a seasonally adjusted basis, with higher output of automobiles and steel accounting for all of the gain. At a level of 165.1 percent of the 1957-59 base, the index in January was about 2 percent below its position last August—the month prior to the GM strike—and was about 5.4 percent below the peak attained in July 1969 (see Chart I). The failure of the index to regain its pre-strike level in January suggests that the fourth-quarter slump in business activity extended beyond the depressing influence of the automotive strike. In part, this development is also attributable to the relatively slow pace at which automobile output has been resumed following the termination of the strike. For example, January automobile production ran at a seasonally adjusted annual rate of 8.3 million units, about 0.2 million units below the production rates recorded in July and August of 1970, thus suggesting little or no catch-up production as of that point. Production data for February, however, indicate that automobile output reached about 9 million units, the largest volume since mid-1969.

Aside from the upward movement in production stemming from higher automobile output—and the partially related gain in steel production—industrial activity showed little change in January (see Chart I). In fact, the total production index excluding the steel and automotive components posted a small decline on a seasonally adjusted basis. Once again, a factor in this turn of events was a further drop in the production of equipment.

In January, manufacturers' sales posted a relatively large gain of $1.1 billion following an impressive rise in December that has been revised upward to $1.8 billion. Much, but not all, of this recent strength reflects higher levels of activity in the motor vehicles and parts industry group which, of course, is a result of strike-recovery activity. However, the January data in particular suggest that the rise in sales was not confined to the automobile and related industries. For example, shipments at manu-



facturers' durables exclusive of motor vehicles and parts rose by $0.4 billion, and sales by nondurables firms rose by $0.3 billion. Despite these gains, however, January sales at durables manufacturers excluding the auto group were still below the volume which prevailed in the August-September period of last year.

Concurrent with the fairly large gain of $1.1 billion in total manufacturers' sales, inventories fell by $0.4 billion in January. Thus, the inventory-sales ratio for all manufacturers dropped to 1.74, about the level which prevailed prior to the auto strike. Much of the decline in inventories reflected a $0.3 billion runoff in stocks at durables manufacturers exclusive of automobile and parts. Accordingly, the inventory-sales ratio for these firms declined from its very high fourth-quarter level. Nevertheless, at 2.30, this ratio is still on the high side by comparison with the experience of the last year and a half.

In January, new orders for durable goods rose by about $1.2 billion, a gain of about 4 percent from the December level. Much of this increase in orders reflected higher bookings for automobiles and steel mill products. Excluding autos and steel, durables orders rose by $0.5 billion or by about 2 percent. At their January levels, orders in the durables industries excluding autos and steel were about 2½ percent above the fourth-quarter average, with the gain spread out among several industry groupings. On balance, the orders situation in January appears to have improved somewhat from recent experience.

RESIDENTIAL CONSTRUCTION ACTIVITY

In January the number of new private housing starts fell by about 16 percent from the December seasonally adjusted rate of 2.0 million units annually. However, at 1.7 million units, January starts were still 17 percent above the average level recorded in 1970. There are reasons to believe that the December figure and thus the January decline were exaggerated by special factors. For example, on a nonseasonally adjusted basis, 54 percent of the December starts were financed by the Federal Housing Administration, up from 28 percent a year earlier. Thus, it may be that the early-December reduction in the FHA mortgage rate caused a one-shot surge in starts. The fact that the fraction of FHA-financed starts dropped back to a more normal 30 percent in January lends credence to this view. There is also the possibility that the recent volatility in housing starts has been exaggerated by seasonal adjustment problems since the seasonal factors for construction activity are always tenuous in the winter months. Along with the fall in housing starts, building permits also declined from their December high. However, here too, the January level of permits was a full 20 percent above the average number of permits issued in 1970 as a whole. In short, indications remain strong that the residential construction sector will be a source of considerable economic strength in 1971.

PERSONAL INCOME AND CONSUMER DEMAND

Personal income posted a relatively large gain of $7.9 billion at a seasonally adjusted annual rate in January. While part of this increase can be traced to special factors, the rise in income exclusive of these nonrecurring elements was about $2 billion more than the average monthly increment in total personal income recorded in 1970. The major factor accounting for the January strength was a $6.8 billion increase in wage and salary disbursements, part of which was attributable to higher payroll employment in January. About a $2.2 billion salary boost for Federal Government employees also contributed to the rise in wage and salary payments. Partly offsetting these gains was a $1.8 billion increase in employee social security tax payments, which are treated as a reduction in personal income. With the exception of dividend payments,

which posted a large $1.8 billion rise, the other components of personal income showed little change. The January gain in dividends was simply a reflection of the fact that the December level of these payments was unusually low because of the failure of a number of companies to pay customary year-end extra dividends.

On the basis of advance information, retail sales posted a 1.1 percent gain in January. This increase followed a rise of almost 1 percent in retail volume in December. In both months, higher sales of durable goods accounted for virtually all of the increment in total retail activity. In turn, stepped-up automobile sales have been a major factor in the recent strengthening of durables purchases. Nevertheless, at their January level, retail durables sales were still below the volume that prevailed in September, the last month in which these data were reasonably free of strike-induced distortions. This would suggest that consumer spending decisions are still being tempered by higher prices, high unemployment, and general economic uncertainties.

LABOR COSTS, PRODUCTIVITY, AND PRICES

The fourth-quarter data on compensation per man-hour, productivity, and unit labor costs were severely distorted by the effects of the GM strike. However, even allowing for this factor, the evidence remains strong that rising wage costs have shown little reaction to the marked increase in unemployment which emerged during 1970. During the final three months of last year, compensation per man-hour in the private economy rose at a seasonally adjusted annual rate of about 6.4 percent, down from the 7.5 percent increase registered in the previous quarter. However, indications are that most—if not all—of this slowing reflected a shift in the composition of employment away from the high-wage industries, which were most affected by the automobile strike, and the concurrent fall in overtime hours worked. For 1970 as a whole, the rise in compensation per man-hour equaled 6.6 percent, only slightly below the 1969 gain of about 7 percent. Considering the reduction in expensive overtime hours in 1970 and—even more importantly—the rise in unemployment, this rather slight moderation in the increase in compensation per man-hour is certainly a disappointing development. By way of contrast, in the other post-Korean war periods of declining economic activity the rate of gain in compensation per man-hour moved decisively lower as the economy slowed.

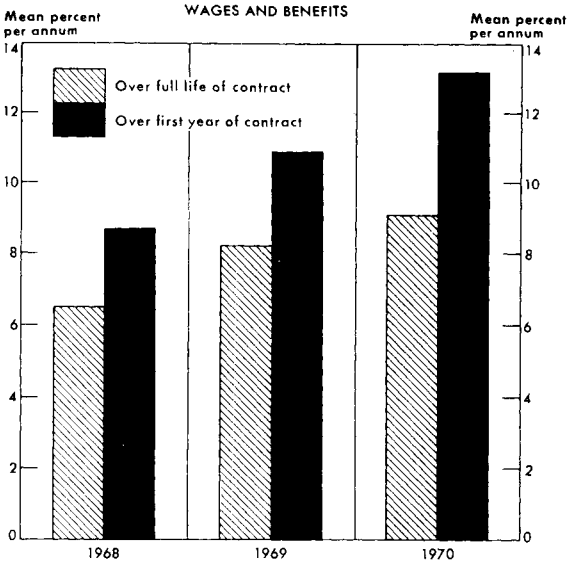
In the fourth quarter, the rise in compensation exceeded by a wide margin the gain in output per man-hour, so that unit labor costs rose at an annual rate of about 5.7 percent. The acceleration in unit labor costs in the October-December period reflected the sluggish growth of productivity in the period. This development was mainly attributable to a pronounced decline in output per man-hour occurring in the manufacturing sector, which in turn was largely the result of the automotive strike. In contrast, during each of the two preceding quarters productivity in the private economy had posted relatively large increases which had yielded some moderation in the rise in unit labor costs. A resumption of a more normal growth of output per man-hour should tend to dampen the impact of rising compensation per man-hour relative to the experience of the fourth quarter. However, even allowing for this eventuality, rapidly rising wage rates are continuing to place severe pressures on the price level.

One factor contributing to the strong upward thrust in wages in 1970 has been the breakneck pace of newly negotiated wage contract settlements (see Chart II). During the four quarters ended in December 1970, the mean increase in wages and fringe benefits in newly negotiated contracts covering 5,000 or more workers was 9.1 percent over the life of the contracts, most of which extend for three years. This contrasts with gains of 8.2 percent and 6.5 percent in 1969 and 1968, respectively. During 1970, the first-year adjustments in these contracts

Chart II

MAJOR LABOR CONTRACT SETTLEMENTS

WAGES AND BENEFITS

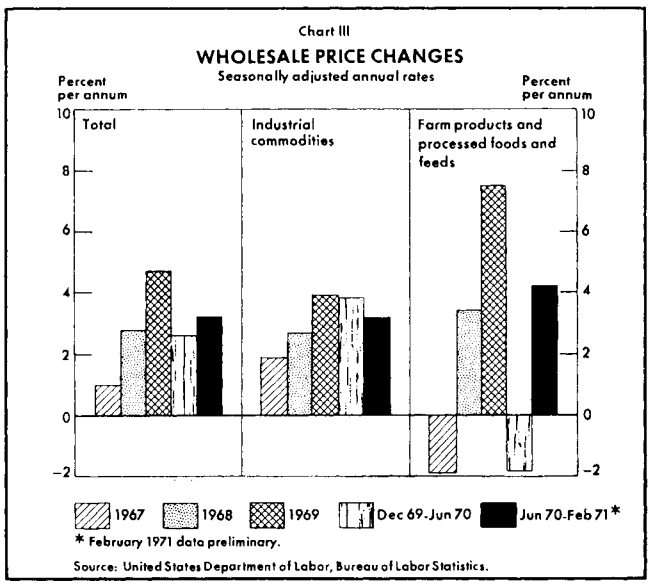


Source: United States Department of Labor, Bureau of Labor Statistics.

amounted to an astounding 13.2 percent. While huge contract settlements have been negotiated in virtually all sectors of the economy, the problem was most severe in the construction industry. For the year ended in December 1970, new contract settlements in the construction sector have resulted in a mean first-year increase in wages excluding fringe benefits of 18.3 percent, while over the life of the contract the rise has amounted to 14.7 percent. While major contract settlements directly affect the wages of only a relatively small share of the work force, the publicity surrounding them is such that their implications far transcend the number of workers involved. Certainly, one necessary step toward significant and permanent progress in the battle against inflation is a scaling-down of the pace of new collective bargaining settlements.

On the price front, the most recent data provide some very tentative signs of an improvement in the underlying inflationary situation. According to preliminary figures—which are sometimes subject to large revisions—the index of industrial wholesale prices increased at a seasonally adjusted annual rate of 1.6 percent in February, about half the rate of gain registered in the past eight months (see Chart III). While industrial prices were moderating, a sharp rise in the index for farm products, processed foods, and feeds resulted in a very rapid 7.6 percent rate of increase in the overall wholesale price index. The acceleration of wholesale agricultural prices was in part attributable to bad weather in the Midwest, which curtailed shipments of livestock.

At the consumer level, January price developments were also somewhat encouraging. The overall consumer price index advanced at a seasonally adjusted rate of 3.4 percent, significantly below the 4.9 percent gain experienced over the second half of 1970. Unchanged food prices accounted for part of this improvement. Indeed, during the past year, moderating food prices have held down the overall increase in consumer prices. In January, however, nonfood commodity prices moderated considerably from recent experience, rising at a seasonally adjusted annual rate of only 2.1 percent. While this development is certainly welcome, it should be emphasized that, over the past two years, one- or two-month slowdowns in this price measure have been quickly reversed.



The Business Situation

The recent performance of most business indicators suggests that domestic economic activity remains fairly sluggish. Indeed, in February the index of industrial production declined despite higher output of automobiles and steel. Moreover, personal income posted only a slim rise in February, and the data for March suggest that the underlying situation in the labor markets remains on the sluggish side. The latest Department of Commerce-Securities and Exchange Commission survey of plant and equipment spending intentions for 1971 indicates a 4.3 percent rise in such outlays. While this increment is slightly larger than that indicated in the previous survey, the magnitude of the increase scheduled for 1971 is still quite modest.

On a more positive note, the inventory-sales ratios in several key sectors have improved somewhat in recent months. Of course, a significant near-term strengthening of sales would pave the way for a more expansionary pace of inventory spending. Moreover, the prospect for such a strengthening in business sales has been enhanced by recent fiscal policy changes. In particular, the new social security legislation will boost social security payments by 10 percent retroactively to the beginning of the year while deferring until 1972 a $2.5 billion increase in social security tax payments that had been budgeted for this year.

Recent consumer price developments have been somewhat encouraging. For the first two months of 1971 the rate of increase in consumer prices slowed considerably from its earlier rapid pace, thus raising the hope that the inflation rate may, at last, be moderating. However, similar improvements in the price situation have emerged in the past only to be sharply reversed. Moreover, in March, industrial wholesale prices rose at a seasonally adjusted annual rate of 3.0 percent, almost double the rise recorded in the prior month. Thus, it is not yet clear that a trend toward a more acceptable pattern of price performance has been firmly established. Moreover, in light of the heavy collective bargaining schedule for 1971, and the large wage gains which will take effect this year on the basis of contracts written in prior years, wage pressures on the price level are likely to remain serious for some time to come.

PRODUCTION, INVENTORIES, AND ORDERS

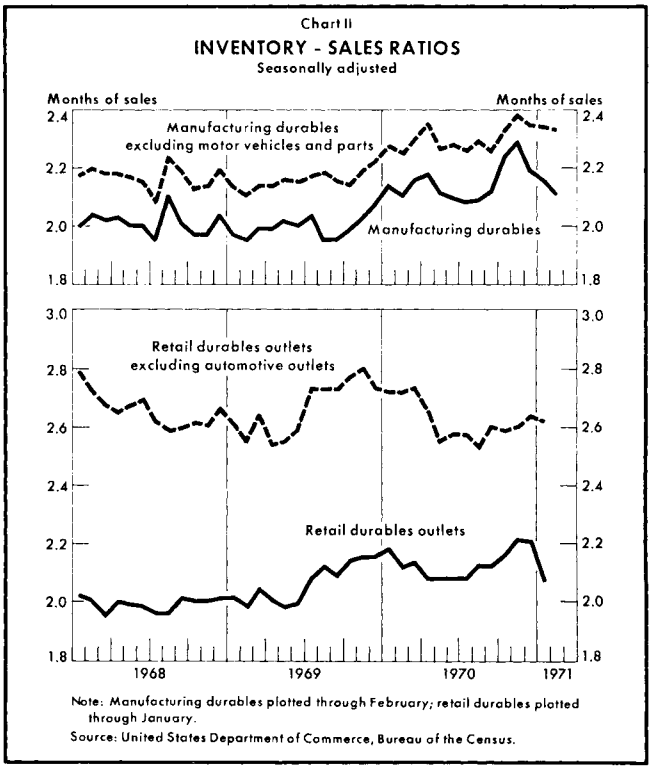
During February, the Federal Reserve Board's index of industrial production edged downward to 164.8 percent of the 1957-59 base, a fall of 0.4 percent on a seasonally adjusted basis. In the previous month, this index had increased as higher automobile and steel output more than outweighed declines in other industry groupings. In February, however, a small gain in automobile output and a 3.9 percent jump in steel production were not sufficient to offset the continued weaknesses in other sectors. Excluding both the automobile and steel components, industrial output fell by 0.6 percent, with production moving lower in virtually all other major groupings. For example, output of consumer goods exclusive of automobiles fell by 0.9 percent, the production of business and defense equipment continued its downward trend, and materials production showed little change.

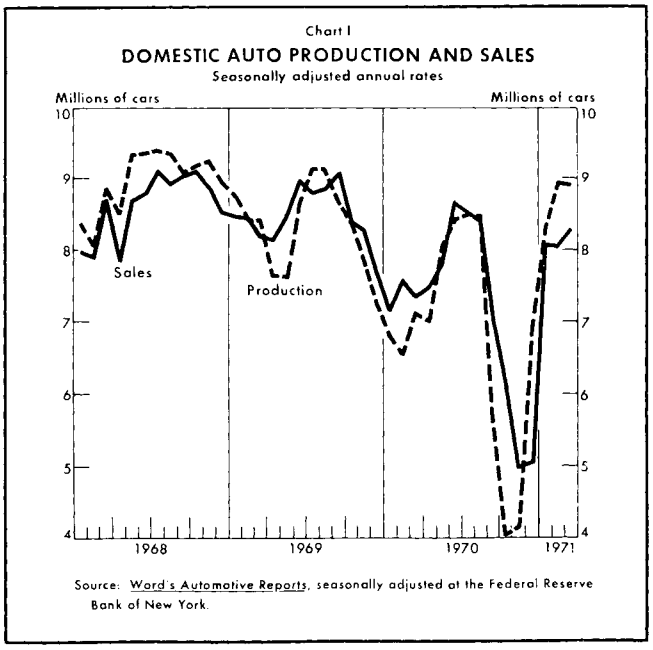
While the lackluster performance of industrial production in recent months has reflected a broad range of factors, a significant cause has been the failure of post-strike gains in automotive production and sales to meet earlier expectations. New passenger car production in March was about unchanged from the February level of a shade under 9 million units on a seasonally adjusted annual rate basis (see Chart I). These production levels are below the volume of output which had been tentatively scheduled for this period at the turn of the year. The failure to meet these earlier production schedules was largely a response to the disappointing level of automobile sales. In the first quarter, sales ran at a seasonally adjusted annual rate of somewhat more than 8 million units, although they strengthened considerably toward the end of March. The first-quarter sales volume was above the depressed level for 1970 but well below the sales volume recorded in 1969. Moreover, because automotive production in each of the four months since the termination of the General Motors strike has exceeded sales, dealer inventories of new passenger cars accumulated over the first quarter. Thus, unless there is a sustained strengthening in automobile sales, there is little likelihood of any large near-term thrust in

production stemming from higher automotive output.

The recent strike-induced movements in automobile production and inventories have tended to distort the overall relationship between sales and inventories. To place these recent developments in better perspective, Chart II shows the inventory-sales ratios for durables manufacturers and retailers both including and excluding the automobile group. As the chart indicates, the durables manufacturers' ratios have improved somewhat in the last three months relative to their very high levels of November 1970. However, at their February positions, both of these manufacturers' ratios still appear a bit high, compared with the experience of the past three years. On the basis of January data, inventory-sales positions of durable goods retailers—both including and excluding the automobile group—are more in line with the behavior experienced in the second half of 1968 and early 1969. In fact, the ratio for durables retailers excluding automobile outlets is below the level that prevailed in the second half of 1969 and early 1970, when inventory spending at these outlets underwent its last significant downward correction. Of course, any substantial strengthening in retail sales would tend to move the ratios lower, thereby paving the way for a more expansionary pace of inventory spending.

In February, new orders for manufactured goods increased by $0.3 billion on a seasonally adjusted basis.





This gain in orders stemmed almost exclusively from a rise in bookings by nondurables manufacturers. In the key durable goods sector, new orders were essentially unchanged from their January level, as a $0.4 billion increase in producers' capital goods orders offset a large drop in steel mill bookings. This gain in capital goods orders was strongly influenced by a large increase in orders in the shipbuilding industry. Meanwhile, the volume of unfilled orders for durables manufacturers continued to rise slightly but remained substantially below the levels that had prevailed in early 1970. In short, the overall orders situation was little changed in February and still does not suggest a significant near-term strengthening in production.

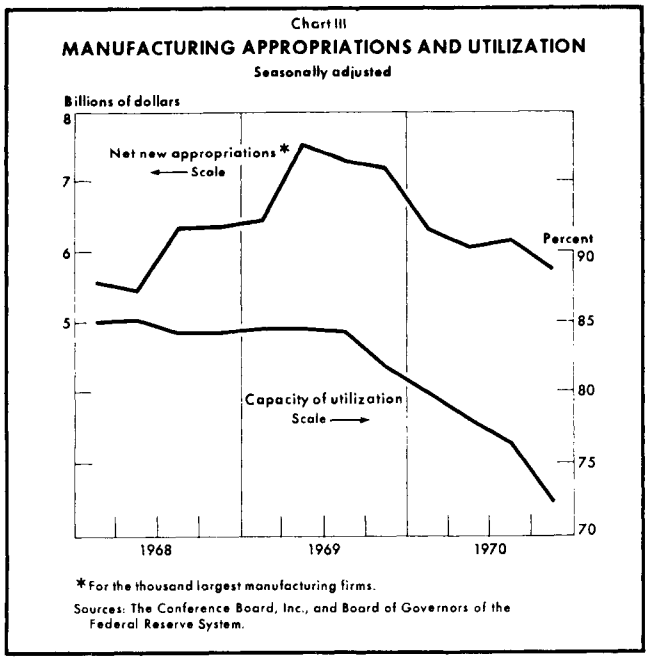
BUSINESS INVESTMENT AND RESIDENTIAL CONSTRUCTION

The most recent Commerce-SEC survey of plant and equipment spending intentions indicates that business firms are planning to increase their plant and equipment expenditures by a modest 4.3 percent in 1971, with most of the gain scheduled for the second half of the year. If these spending intentions are realized, the year-over-year

rise in this spending component in 1971 would be somewhat smaller than the 5.5 percent increase registered in 1970. Moreover, in real terms, this increment in spending may imply no change in the accumulation of new capital goods in the current year.

The rise in spending reported in February is somewhat higher than the level indicated in the survey taken last fall that had reported a slim 1.4 percent planned increase in spending for 1971. In part, however, the larger increment now scheduled is a reflection of the fact that actual spending in the fourth quarter of 1970 fell below the level of outlays that had been projected in the November survey. This shortfall in expenditures was partly attributable to reduced purchases of motor vehicles by businesses during the GM strike.

In terms of industry groupings, all of the increase in expenditures planned for 1971 is scheduled for the nonmanufacturing sector, with more than half of the gain arising in the public utilities sector. Despite the general sluggishness in the economy, capacity strains in the public utilities sector have remained quite severe. In contrast, among manufacturing firms, the February survey indicates that plant and equipment outlays in 1971 will be slightly less than the spending level reached last year with virtually every durables industry group in the manufacturing sector scheduling declines in early 1971. Of course, the more distinct weaknesses in spending intentions by manufacturing firms are—among other things—a reflection of sluggishness in output relative to industrial capacity, which has characterized the last year and a half. Indeed, recent data show that manufacturing firms have been operating at a rate utilizing only about three fourths of their capacity (see Chart III). Depressed levels of corporate profits have also tempered the willingness of business establishments to embark on major new capital spending projects.



The sluggish near-term outlook for manufacturers' spending for plant and equipment portrayed in the Commerce-SEC survey is consistent with the latest Conference Board survey of capital appropriations by large manufacturing firms. The latter survey shows a relatively large 7.2 percent drop in net new appropriations in the fourth quarter of 1970 to a level of $5.7 billion (see Chart III). These appropriations, which are often a useful advance indicator of future capital spending, had peaked at $7.5 billion in the second quarter of 1969.

In February, private housing starts remained virtually unchanged at the 1.7 million unit seasonally adjusted annual rate recorded in January. However, the average number of starts initiated in the first two months of 1971 was about 18 percent above the average for 1970 as a whole. Moreover, the February composition of starts shifted toward single-family structures. In fact, single-family starts rose to a seasonally adjusted annual rate of 975,000 units which—except for the unusually high December 1970 figure—was the largest number of single-family structures begun in any month since December 1968. Normally, a shift toward single-family structures implies a somewhat stronger course of spending for residential construction, since these units typically have a higher per unit value than do multifamily housing units. Thus, while housing starts failed to rise in February, the evidence remains convincing that the increased availability and reduced cost of mortgage credit will continue to stimulate spending for residential construction in the coming months.

EMPLOYMENT, PERSONAL INCOME, AND PRICES

In March the unemployment rate edged upward by 0.2 percentage point, thereby erasing the drop which had occurred in February. The rise in the unemployment rate reflected a decline of 62,000 in the number of employed persons as measured by the household survey and a fairly small rise in the size of the labor force. Among the principal labor force components, the most significant increases in unemployment rates occurred among women in the 20 to 24 age-bracket and among teen-agers of both sexes. For the first quarter as a whole, the unemployment rate

averaged 5.9 percent, unchanged from the fourth quarter of 1970. According to the payroll survey, total employment was essentially unchanged in March, as small increases in some sectors offset a decline of 63,000 in manufacturing employment. Since last September, manufacturing employment has declined by 630,000 workers or by about 3.3 percent. The March payroll survey also indicates that the average workweek of production workers in manufacturing rose 0.4 hour from the February figure. Hours worked in February had dropped sharply, probably as a result of seasonal adjustment problems associated with the Lincoln's Birthday holiday. On balance, however, the labor market data for March and for the first quarter as a whole do not indicate any improvement in the underlying situation. At best, the data suggest that the sharp deterioration of labor market conditions which characterized much of 1970 may have stabilized.

The growth in personal income, which was restrained by the declines in employment and hours worked, amounted to $2.2 billion in February. This increment in personal income was only about three fifths of the average monthly rise in income last year. Overall wage and salary disbursements rose by about $1.6 billion. In the manufacturing sector, however, wage and salary payments actually declined, as particularly large decreases in payrolls were recorded in the apparel, fabricated metals, machinery, and chemical industries. All the nonwage and salary components of personal income showed little change in February, thus rounding out a rather dismal performance of personal income in that month.

For the second consecutive month the rate of increase in consumer prices lessened significantly in February relative to the very rapid increase experienced in the past several years. On a seasonally adjusted basis, the overall consumer price index rose at an annual rate of 2.0 percent following the 3.4 percent rate of increase in January. The slowing in consumer price increases in February materialized despite the fact that food prices—which make up about one fourth of the overall index—rose at an annual rate of 5.2 percent. In contrast, prices of nonfood commodities on a seasonally adjusted basis declined at a 1.0 percent annual rate, the first such fall in this measure of prices since February 1965. Services prices also moderated appreciably in February, posting their smallest monthly increase since April 1967. In large part, however, the moderation in services prices reflected the sharp drop in rates on home mortgages. On the whole, the performance of consumer prices in February, coming on the heels of the January improvement, raises the hope that the inflation rate may at last be moderating. However, it would be a mistake to draw sweeping conclusions from two months' data. Only last year, a similar slowdown in the rate of consumer price increases in July and August was followed by the resumption of rapid inflation.

In March, industrial wholesale prices rose at a seasonally adjusted annual rate of 3.0 percent, almost double the increase registered in February. Most of this acceleration was caused by higher prices for materials used in construction, including lumber and structural steel. For the three months ended in March, industrial wholesale prices increased at an annual rate of 2.8 percent, significantly below the pace for 1970 as a whole but still a rapid increase considering the sluggishness in the economy. Wholesale agricultural and food prices rose at a seasonally adjusted annual rate of about 1 percent in March, after having posted very large gains in the two preceding months. Reflecting this marked slowing in food price increases, the overall wholesale price index also moderated in March and posted a gain of 3.3 percent on a seasonally adjusted annual rate basis.

The Business Situation

Recent developments suggest that the economy may be resuming an expansionary course. Housing starts and building permits showed renewed strength in March, suggesting that further gains in residential construction spending are likely to emerge in the coming months. Similarly, the continued large volume of state and local government bond financing indicates some additional spending thrust from this sector. However, the extent of overall economic growth for the balance of the year depends critically on the behavior of consumer spending. In the first quarter, consumer expenditures as recorded in the gross national product (GNP) accounts posted a large increase which was primarily the result of the rebound in spending on motor vehicles from its strike-depressed fourth-quarter level. However, advance retail sales data for March and some sketchy data for April suggest that consumer outlays for nonautomotive durables, as well as nondurable goods, have been gaining some momentum. In the second quarter, a boost in personal income resulting from increased social security benefits may reinforce this apparent move toward a stronger underlying pace of consumer spending.

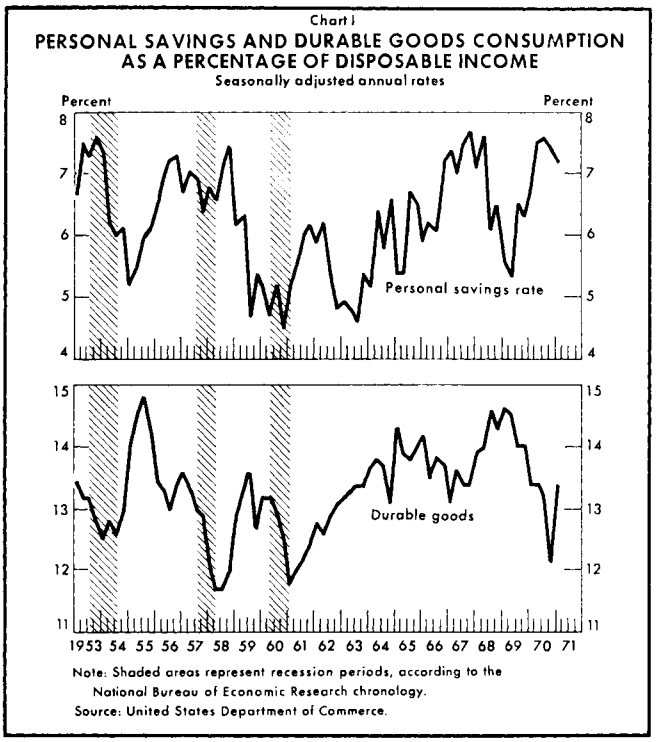
Although there were some encouraging developments during the first quarter, a clear trend toward a broad-based moderation of inflationary pressures has not yet emerged. On the positive side, the rate of increase in consumer prices slowed somewhat during the first three months of the year. On the other hand, even allowing for the influence of special factors, the GNP deflator continued to rise at a rapid rate. Prices of wholesale industrial commodities, moreover, spurted sharply in April after having moderated in the first quarter. Furthermore, compensation per man-hour increased by about 7 percent over the past year, a rate of gain which has not abated despite the marked rise in unemployment.

GROSS NATIONAL PRODUCT

A $28.5 billion rise in the market value of the nation's total output of goods and services during the first quarter raised GNP to a seasonally adjusted annual rate of $1,018.4 billion, according to the preliminary estimates of the Department of Commerce. Just as the previous quarter's GNP had been depressed by the General Motors strike, the first-quarter gain in GNP was swelled by the rebound of activity from the strike. The average quarterly increase in GNP over the two quarters was a modest $16.5 billion. Real GNP rose at a seasonally adjusted annual rate of 6.4 percent in the first quarter in 1971, with the gain in automotive production more than accounting for the increase. Over the two quarters ended in March, real GNP rose at a very low annual rate of 1.1 percent.

The first-quarter increase in final expenditures—that is, GNP less the inventory component—amounted to almost $30 billion, with 60 percent of that gain arising from the consumer sector. The overall gain in consumer spending reflected higher outlays for durable and nondurable goods as well as for services. The rise in consumer outlays for services was in line with recent experience, while the gain in purchases of nondurables was of modest proportions. On the other hand, durables spending increased by a large $10.8 billion, a gain of 12.7 percent. This expansion in durable goods expenditures pushed the ratio of consumer durables outlays to disposable income to 13.4 percent. In the past, similar movements in this ratio have tended to signify a cyclical strengthening in the economy (see Chart I). However, inasmuch as virtually all of the first-quarter strengthening in durables spending reflected the recovery in automobile sales from their strike-depressed fourth-quarter level, these first-quarter data do not indicate a firm trend. There were indications, however, that consumer spending on nonautomotive durables as well as on nondurable goods was quickening toward the end of the quarter.

Although there was a large overall first-quarter gain in consumer spending, the savings rate declined by only 0.2 percentage point to 7.2 percent—still about 1 percentage point above its average level for the last two decades (see Chart I). The high savings rate, coupled with the large rise in consumer outlays, was made possible by the gain in disposable personal income in the first three months of 1971. Indeed, fueled by higher personal income payments



including the Federal pay boost and by the lower Federal income tax withholdings which took effect on January 1, 1971, disposable income jumped by almost $18 billion. In the current quarter, moreover, both personal income and disposable income will be stimulated further by the large increase in social security benefits that was recently signed into law. This added flow of income raises the possibility that consumer spending will provide additional upward thrust to economic activity in the coming months.

Residential construction spending and outlays by state and local governments, both of which have benefited from improved financial market conditions, were also major sources of strength in the overall first-quarter rise in final demand. For example, spending on residential construction rose by $3.2 billion, bringing the cumulative increase in this spending component over the last three quarters to $7 billion or 25 percent. Moreover, additional gains in residential outlays are likely in the months ahead. For example, after having leveled off in February, housing starts and building permits showed renewed strength in March. Perhaps more importantly, the availability and cost of mortgage credit continued to improve dramatically. During the first quarter, deposit flows to the nation's thrift institutions—the major suppliers of residential mortgage credit—amounted to a record 23 percent on a seasonally adjusted annual rate basis. The effective interest rate on conventional mortgages declined to 7.66 percent in March, 86 basis points below the record high of 8.52 percent reached in August 1970. In addition, over this seven-month period, the loan-price ratio on these mortgages increased, indicating a lowering in downpayment requirements for borrowers.

Improved capital market conditions were also instrumental in the first-quarter surge in purchases of goods and services by state and local governments that amounted to $4.9 billion. Indeed, while payroll costs of these governmental units continue to show a strong upward trend, the overall rise in spending has been given added thrust by the record volume of debt that has been marketed in the last several months. For example, in the nine-month interval ended in March 1971, the tax-exempt bond market absorbed an estimated $16.8 billion in new state and local bonds, up 42 percent over the amount issued in all of 1969. Many of these issues had been scheduled for marketing in 1969 or earlier in 1970 but were postponed because of high interest rates and generally unfavorable credit market conditions. The bonds issued over the last nine months have implications for spending well beyond their contribution to the first-quarter increment in state and local outlays. Inasmuch as most of these issues are used to finance capital projects—new structures, roads, sewers, and the like—their full impact on spending involves a lag of at least several quarters.

Business fixed investment spending rose by $3.8 billion in the first three months of 1971, the largest such gain since the third quarter of 1969. Much of this strength was merely a reflection of the rise in business purchases of automobiles and trucks from the strike-depressed fourth-quarter level. Apart from strike-related factors, business fixed investment expenditures were higher, primarily because business outlays for structures posted a large gain in the first quarter after having declined in four of the preceding five quarters. While these first-quarter data on business investment spending may show a bit of improvement relative to the experience of the last several quarters, the underlying situation for this spending component remains on the sluggish side. The latest survey by McGraw-Hill on corporation plant and equipment expenditures indicated a modest 4 percent increase for this year. This increment is in line with the rise indicated in the recent survey by the Department of Commerce-Securities and Exchange Commission as well as the survey by Lionel D. Edie.

Net exports and Federal Government purchases of goods and services, the remaining two components of final demand, were virtually unchanged in the first quarter.

Net exports expanded by $0.2 billion, while Federal purchases fell by $0.1 billion. The decline in Federal outlays, which occurred in spite of the $2.2 billion pay increase that took effect in the period, reflected the continuing decrease in defense purchases.

On the basis of preliminary data, the rate at which businesses accumulated inventories declined slightly in the first quarter, thereby serving as a restraint on the overall expansion of GNP. The buildup of automobile inventories by dealers who were replenishing their strike-depleted stocks accounted for the inventory investment that did occur, indicating little change of inventories in other sectors. The lack of any accumulation of nonautomotive stocks has created a better balance between the level of inventories and the corresponding volume of sales. With the resulting lower inventory-sales ratio, a pervasive upsurge in sales activity would tend to promote a more expansionary pace of inventory spending.

PRICES, LABOR COSTS, AND PRODUCTIVITY

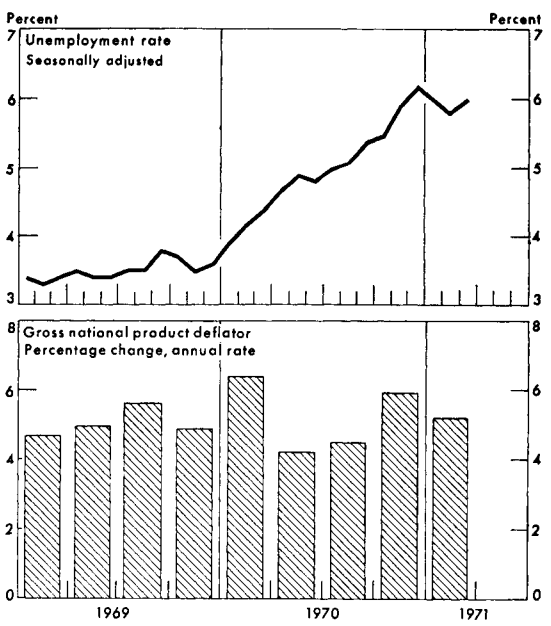
Taken as a whole, the performance of prices has continued to be unsatisfactory, although recent movements in consumer prices have been encouraging. Compared with a 5.5 percent annual rate of increase during 1970, the consumer price index (CPI) rose at a 2.7 percent annual rate in the first three months of 1971. The implicit GNP price deflator rose at a seasonally adjusted annual rate of 5.2 percent in the first quarter of 1971, little changed from the performance of other recent quarters (see Chart II). In fact, because the weights used in calculating the deflator are based on the current composition of output and because there was a first-quarter output surge in the automotive industry—a sector with a low deflator—the rate of increase in the deflator was restrained. For example, using the output weights of the fourth quarter of 1965, the annual rate of increase in the GNP price deflator climbed from 5.1 percent in the last quarter of 1970 to 5.9 percent in the first quarter of 1971. In part, the disparity between the first-quarter performance of the GNP deflator and of the CPI can be attributed to their different coverage. For example, the Federal pay raise added to the GNP deflator without directly affecting the CPI. Moreover, lower interest rates on home mortgages and lower used-car prices, which were major factors in the moderating trend in consumer prices, do not directly influence the GNP deflator. The rapid increase in the GNP deflator suggests that a firm trend toward a more satisfactory price performance has not yet been established. This was underscored by a sharp spurt in industrial wholesale prices in April after more moderate increases in the first quarter. Over the first four months of 1971, industrial wholesale prices advanced 3.7 percent on a seasonally adjusted annual rate basis, virtually the same as the increase registered in 1970 as a whole.

The events of the past year with respect to the observed relationship between the rate of inflation and the level of unemployment seem to run contrary to the post-Korean war experiences. Since the beginning of 1970, the unemployment rate has risen from 3.9 percent to about 6.0 percent, while the rate of inflation as measured by the GNP deflator has remained at about 5 percent (see Chart II). This apparent deterioration in the trade-off between inflation and unemployment may reflect several considerations, such as the duration and intensity of the inflation since 1965 which may have changed expectations of price movements. In addition, there have been demographic shifts in the composition of the work force. For example, the relative number of 16- to 24-year olds in the work force—a group with a high unemployment rate—has increased substantially in the past decade.

Whatever the significance of such factors in explaining the failure of the general price level to respond more quickly to the sluggishness in the economy, the situation

Chart II

UNEMPLOYMENT AND INFLATION



Sources: United States Department of Labor, Bureau of Labor Statistics, and the United States Department of Commerce.

is even worse in terms of the degree to which labor prices have failed to respond to the marked rise in unemployment. In the first quarter, compensation per man-hour in the private economy, measured from a year earlier, rose by a rapid 7.3 percent. Moreover, the increase in compensation per man-hour over the last three years has remained in the neighborhood of 7 percent. Thus, there is no evidence of a slowing in the rate of increase in this broad measure of labor costs per man-hour.

While the rate of increase in compensation per man-hour was essentially unchanged in the first quarter, output per man-hour did register a strong showing. Measured from a year earlier, the growth in this measure of productivity for the private economy was 3.4 percent. This was the strongest productivity increase in three years and was about equal to its long-term trend rate of growth (see Chart III). Over the last year, there has been a movement toward a cyclical strengthening in productivity which, of course, tends to absorb some of the rise in labor costs. However, even with the strong first-quarter gain in productivity, unit labor costs continued to rise rapidly, posting a 3.8 percent gain over the level which prevailed a year earlier. While this represents a significant improvement over the experience of the past three years, it should be noted that, around cyclical upturns in business activity, an increase in unit labor costs as high as 3.8 percent is virtually without precedent. Thus, the strengthening in productivity to date has not been sufficient to stabilize unit labor costs, primarily because the rise in compensation per man-hour has not moderated in response to the slowing of economic activity.

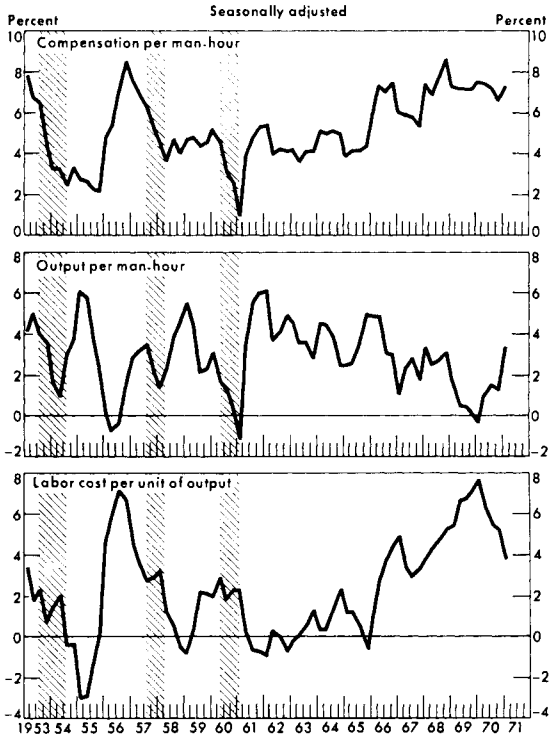
Moreover, the first-quarter data on major labor contract settlements provide little basis for hope of a significant decline in the rate of increase in compensation rates. For example, the contracts negotiated in the first quarter provided for an 8.5 percent increase in wages and fringe benefits over the life of the contract for the 600,000 workers whose representatives signed settlements in this period. While this represents a very slight moderation from the gain of 9.1 percent registered in 1970, the first-quarter increase is still extraordinarily large by historical standards. Of course, contract settlements in the current year tell only part of the story, since a large segment of the workers covered by these major contracts will receive wage adjustments in 1971 on the basis of contracts written in the last year or two. In the current year, almost half of the 10.9 million workers covered by major collective bargaining agreements will receive deferred wage increases averaging 7.8 percent, compared with a 5.6 percent average deferred increase won in 1970. The 7.8 percent figure does not include any wage adjustments that will materialize on the basis of cost-of-living escalation provisions which, in turn, will influence wage rates for about 3 million workers this year. In short, viewed in terms of either the behavior of compensation per man-hour or recent developments in labor contract settlements, wage inflation is still a very serious problem.

Chart III

LABOR COMPENSATION, PRODUCTIVITY, AND UNIT LABOR COST IN THE PRIVATE ECONOMY

CHANGE FROM FOUR QUARTERS EARLIER

Seasonally adjusted



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

The Business Situation

There are increasing signs that the economy is emerging from last year's recession. Restrained inventory spending and gains in sales have substantially improved the balance between stocks and sales, and thus stepped-up inventory spending could soon provide some additional stimulus to the economy. Also, the rebound in residential and public construction appears firmly established, and activity in the industrial sector—while still mixed—seems to have picked up a bit even outside the automobile and steel industries. The indications of an underlying strengthening in economic activity are still limited, however, a fact that is underscored by the softness in personal income and new orders for durable goods in April.

There have been some encouraging developments on the price front, but the pace of inflation remains swift. Thus, while consumer nonfood commodity price increases have moderated significantly over the four months ended in April, a sizable part of the slowing in the overall consumer price index reflects the dramatic fall in home mortgage interest rates. At the same time, industrial wholesale prices rose sharply in April and May. For the first five months of the year these prices advanced at an even higher rate than that experienced in 1970. Moreover, recent announcements of further price advances for a number of metals and metal products underscore the likelihood of continued upward pressure on industrial wholesale prices and, eventually, prices of consumer goods.

PRODUCTION AND ORDERS

Led by a strong increase in iron and steel production, the pace of industrial activity again rose in April, as the Federal Reserve Board's index of industrial production advanced 0.3 percent. By April, the index had risen 2.8 percent from its recent November low but was still 4.9 percent below the July 1969 peak. Close to one third of the recovery in the last five months reflects rising output in the steel industry, where inventory stockpiling as a hedge against a possible July 31 strike has been sizable. A little better than another third of the advance since November reflects increased automobile output following the end of the strike at General Motors.

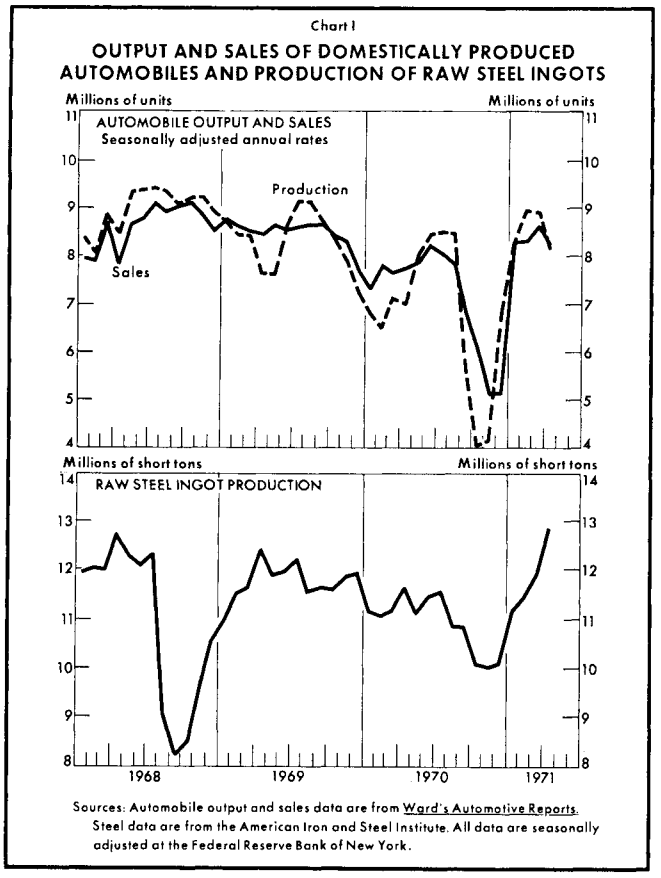
Aside from the automotive and steel industries, recent trends in production have been mixed, though output was up on balance in April. Production of consumer goods other than automobiles has moved up rapidly in the last two months. However, the long downtrend in both business and defense equipment production has continued. Moreover, the latest survey of business plans for plant and equipment investment, taken by the Department of Commerce and the Securities and Exchange Commission in late April and May, indicates such spending will rise this year by only 2.7 percent, and that on a real basis spending will decline. Thus, there seems to be little prospect for a pickup in business equipment output in the near future.

The recovery in automobile sales has been less than had been anticipated by many industry observers. Sales of domestic automobiles, which had dropped to a 5.8 million unit seasonally adjusted annual rate during September through December of last year, have fluctuated narrowly around an annual rate of 8.3 million units during the first five months of 1971 (see Chart I). While this was above the pre-strike sales rate which averaged 7.8 million units in the first eight months of 1970, it remained below the 8.5 million unit average of the previous two years. One factor accounting for the relatively modest pace of domestic passenger car sales in recent months may be the strength of imported car sales. Over the October-April period, imported car sales ran at a seasonally adjusted annual rate of 1.5 million units, well above the 1.2 million units averaged in the first nine months of last year.

In contrast to the relatively flat trend that has prevailed in the automotive industry this year, steel output has climbed rapidly in response to inventory stockpiling demand. However, production is expected to fall off sharply after midsummer—whether a strike occurs or not

—as steel users work off their surplus stocks. In the previous two steel contract cycles, when strikes were also feared, the peak in production occurred in May and in the following two months the mills concentrated on finishing and shipping. In both cases, there was no strike but production fell drastically after the new contracts were signed. The current inventory buildup has not been especially large. Indeed, it appears about the same or perhaps even a bit smaller than the 1968 experience. The somewhat smaller inventory buildup, the weak demand by capital goods and commercial building industries, and the only moderate demand by car makers have helped keep production levels down below their 1968 record. In the first five months of 1968, raw steel ingot production averaged 12.3 million tons a month, compared with 12.0 million tons in the same period this year.

The big drop in new orders for durable goods in April underscored the hesitant nature of the recovery in the industrial sector. In that month, total orders fell $1.2 billion, with volume for transportation equipment plunging $0.7 billion. A sharp drop in automobile orders from an abnormally high March level and a decrease in aircraft orders were the major factors in this unusually large transportation equipment decline. Prior to the April performance, the overall orders series had been moving up strongly from its recent October low. Most of this strength was due to the auto recovery, although orders received by other manufacturers also rose.

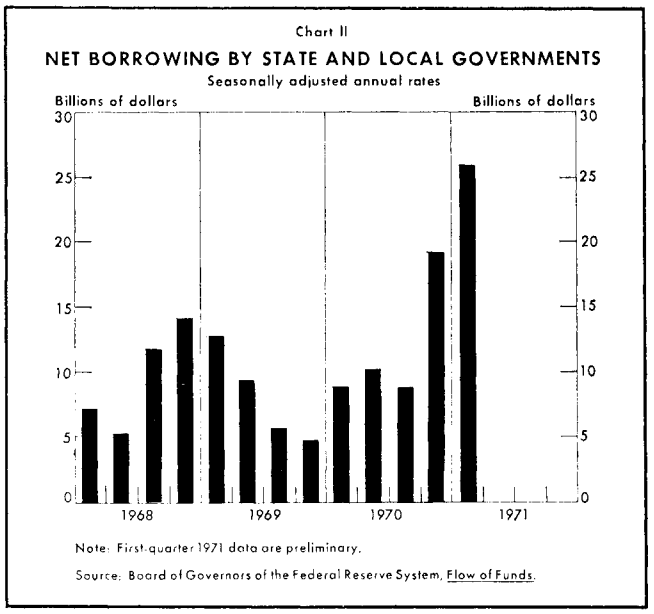


CONSTRUCTION

In contrast to the still somewhat mixed picture in the industrial sector, construction activity has picked up on a broad front. In the first four months of this year, outlays for new construction (seasonally adjusted) have run 11.8 percent above the 1970 average. Private residential housing has accounted for almost two thirds of this gain, but renewed strength in public construction—which includes such projects as roads, schools, and hospitals—also contributed to the overall advance.

The easing in financial conditions since mid-1970 has been a major factor behind the strength in both private residential and public construction. In the public sector, spending had been dampened by the postponement of many state and local bond issues in the past two years, when market interest rates soared to record levels. In many cases these levels exceeded the statutory limits on the rates these borrowers could pay. The subsequent declines in interest rates were accompanied by a phenomenal increase in capital market borrowing by state and local governments (see Chart II). Borrowing surged in the fourth quarter of last year and then climbed by another 35 percent in the first three months of this year. Indeed, state and municipal net borrowing in the credit markets in the first quarter of this year was two and one-half times the year-ago amount. This suggests that further gains in public construction spending are very likely.

The residential mortgage market has also improved markedly. Deposits at savings institutions rose strongly in the second half of 1970 and then in the first quarter jumped by an unprecedented 21 percent (see Chart III). During the same period, mortgage loans held by these institutions rose 8.9 percent. The relatively large spread between the rate of growth of deposits and the growth of mortgage lending reflects several considerations. Part of the huge flow of deposits has been used to rebuild liquidity positions and, in the case of member savings and loan associations, to repay previous borrowings from the Federal Home Loan Banks. In addition, a relatively large volume of the recent deposit flows has been used by mutual savings banks to make investments in high-grade corporate bonds. However, even allowing for these factors, the surge



in deposits at the thrift institutions has been large enough to provide ample funds for further increases in mortgage lending. Underscoring this fact, outstanding mortgage commitments at all savings and loan associations and at New York State mutual savings banks rose to a record total of $12.5 billion in March. Indeed, for the first quarter as a whole, outstanding commitments averaged $10.9 billion, up 16.7 percent from the fourth-quarter average. The vigorous tone in residential construction has also been evident in the recent performance of housing starts and, to a lesser extent, of building permits. In March and April, housing starts ran at a seasonally adjusted annual rate of over 1.9 million units, compared with a 1970 total of less than 1.5 million units. Moreover, during these same two months, the volume of building permits issued by local authorities averaged more than 20 percent above the 1970 average.

BUSINESS INVENTORIES AND SALES

Businesses have continued to accumulate inventories at a modest pace and that, together with the recent strengthening in sales activity, has generated a marked improvement in inventory-sales ratios. The lower level of these ratios at the end of the first quarter has possibly paved the way for a more expansionary pace of inventory spending if sales continue to advance. Inventory accumulation, as reported in the gross national product (GNP) accounts, fell from the relatively moderate seasonally adjusted annual rate of $5.5 billion in the third quarter of 1970 to $3.6 billion in the fourth quarter and to $1.4 billion in the first three months of this year.[1] The first-quarter figure was inflated by the rebuilding of strike-depleted stocks in the auto industry and by strike-hedging gains in steel inventories. Excluding these special factors, inventory accumulation was negative. In April, the book value of inventory spending by manufacturers (the only April component now available) recorded a small increase following two months of decline.

The broad-based improvement in inventory-sales ratios has resulted from a better sales picture as well as from the reduced rate of inventory accumulation. In manufacturing, shipments advanced by a monthly average of $650 million in the first four months of the year. Excluding shipments of the recovering automotive industry, sales were still up strongly. At retail, there are some indications of a revival in consumer demand. Following the lackluster performance of 1970 that continued into the first two months of this year, sales at retail outlets recorded a big —and broadly based—jump in March, and then advanced further in April.

PERSONAL INCOME AND EMPLOYMENT

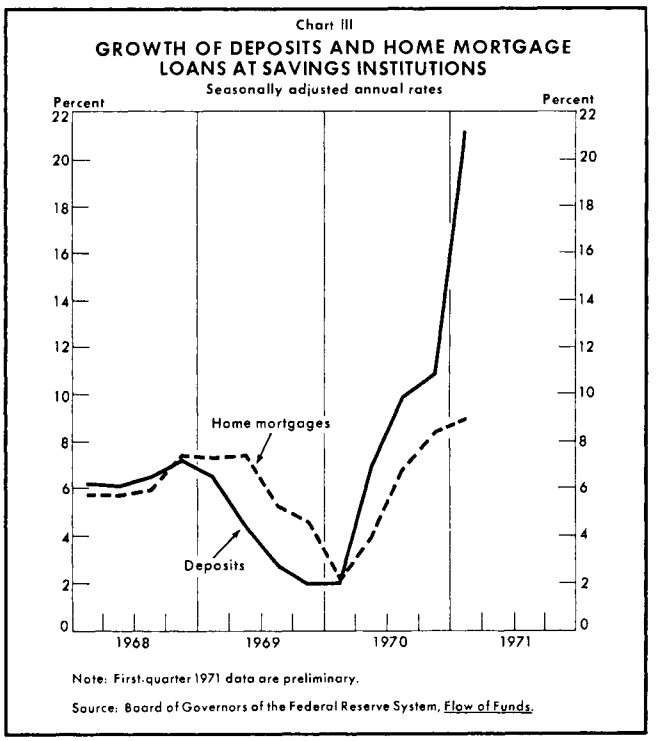
A number of special factors have buoyed personal income in recent months. Excluding these factors, however, growth of personal income has been on the weak side. During the first quarter, the strike recovery and the Federal pay raise helped to lift the average monthly income advances to a $6.4 billion rate, almost twice the 1970 average increase. However, in April, personal income rose only $4.5 billion despite a $1.2 billion rise in transfer payments.

Wage and salary disbursements have been held down by the weakness in the labor markets in the last year or so. As is typical in a downturn, employment in the manufacturing sector has been most affected, and has generally been declining since the summer of 1969. In May the total number of persons on the payroll in manufacturing

[1] In its revised estimate of first-quarter GNP, the Department of Commerce reduced its estimate of inventory spending by $1.0 billion to $1.4 billion. Personal consumption expenditures were revised up by $1.7 billion. Other components were little changed but, when combined, added another $1.6 billion. Total GNP was thus revised up by $2.3 billion to a seasonally adjusted annual rate of $1,020.7 billion. On a real basis, however, GNP was revised up by only $1.1 billion to $732.7 billion. The implicit price deflator is now estimated to have risen by 5.6 percent in the first quarter rather than the 5.2 percent originally estimated

was 1.6 million below the September 1969 peak. Throughout the recession there has been some growth of jobs outside manufacturing, but this has not been large enough to offset the declines in factory payrolls. Thus, total employment is still below its March 1970 peak.

According to the employment series based on a survey of households rather than firms, the unemployment rate rose to 6.2 percent in May, after averaging 5.9 percent in both the final quarter of 1970 and the first three months of 1971. The rise in the unemployment rate was entirely due to a surge in labor force growth in April and May, as employment increases in those two months were relatively good. While civilian labor force growth in the past two months has been strong, the increase over the first five months of 1971 as a whole ran at a moderate 1.6 percent seasonally adjusted annual rate. The rise in the civilian labor force over that period did not exceed employment increases by a wide margin, and the relatively narrow gap between the two prevented the unemployment rate from rising substantially further than it did. During a recesion, there is typically a decline in labor force participation rates, which tends to dampen labor force growth. The civilian work force probably would have risen even more slowly this year but for the reductions in armed forces personnel. Military cutbacks also boosted civilian labor force growth in 1969 and 1970. During those two years the civilian labor force grew by a rapid 2½ percent per annum. The number of persons on active military duty in the armed services had peaked at 3.5 million in June 1969, fell to 3.1 million by June 1970, and is estimated to be 2.7 million in June of this year. Based on the Federal budget estimates for fiscal 1972, armed forces personnel on active duty will number 2.5 million in June of next year.



RECENT PRICE DEVELOPMENTS

The rate of increase of the overall consumer price index slowed in the December-April period to a seasonally adjusted annual rate of 2.9 percent, compared with a 5.5 percent rise for all of 1970. All of this slowing resulted from an improvement in nonfood commodity prices and mortgage interest rates. Elsewhere prices have continued to rise sharply, particularly in the food component where the advance in the first four months of the year amounted to a seasonally adjusted annual rate of 7.0 percent. The recent behavior of consumer nonfood commodity prices has been encouraging. These prices have risen at a seasonally adjusted annual rate of 1.3 percent so far this year, down sharply from last year's advance of almost 5 percent. In terms of slowing the overall index, the fall in home-mortgage interest rates this year was even more important than the easing in the rate of increase of nonfood commodity prices. Excluding this decline in mortgage rates, the overall price index has shown some improvement over last year's performance, but the moderation is not nearly so dramatic as it might otherwise appear.

The recent slower rates of consumer price increases have been cited as evidence of some dampening of inflationary trends. However, the wholesale price situation has remained wholly unsatisfactory and, until there is a clear moderation in the trend of these basic prices, the conclusion that an overall slowing has begun would seem premature. For the first five months of this year, increases in a broad spectrum of industrial goods—such as steel, copper, coal, and lumber—have kept industrial wholesale prices rising at a seasonally adjusted annual rate of 4.0 percent. This rate is even higher than the 3.6 percent increase recorded for all of 1970. Moreover, the stability of agricultural prices which characterized 1970 appears to be over. The wholesale price index for farm products, processed food, and feed rose at a seasonally adjusted annual rate of 7.4 percent over the five months ended in May of this year, compared with a decline of 1.1 percent last year.

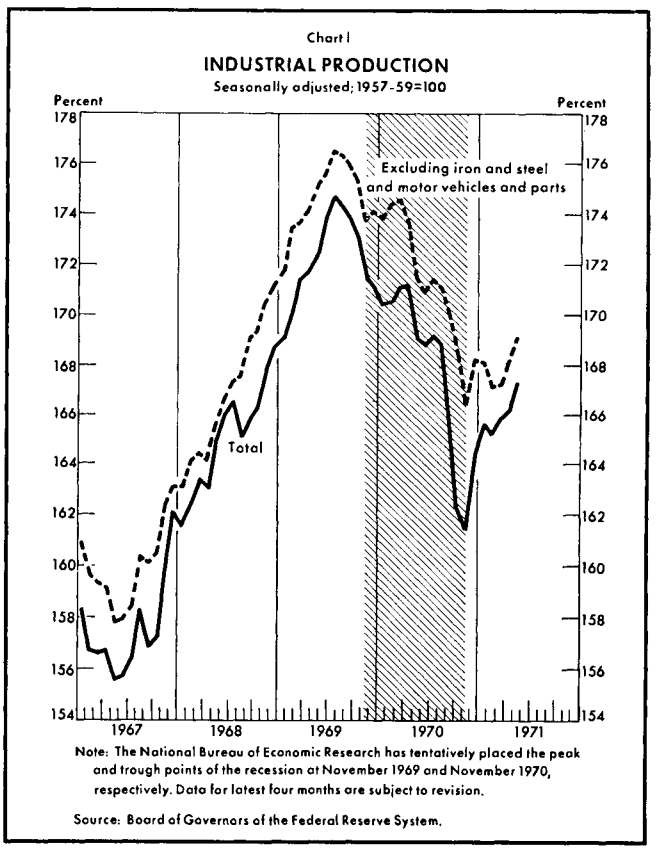
The Business Situation

The economic recovery continues to be moderate. Thus, although industrial production posted a strong and broadly based advance in May, the overall recovery from the November trough is still relatively small. The decline in the unemployment rate in June to 5.6 percent from May's reported 6.2 percent was associated with a record fall in the civilian labor force, suggesting that the reduction in the unemployment rate may not necessarily signify an important improvement in labor demand conditions. Personal income registered a relatively large increase in May, although growth of personal income this year has so far been modest when special factors are excluded. In June, personal income soared as the rise in social security benefits took effect. This initial payout included lump-sum retroactive payments to the first of the year, so that the total advance in income was huge. One area of major strength continues to be the residential construction sector, and a very large jump in building permits during May suggests that further gains are quite possible over the near term. The overall inventory situation appears to be favorable. The pace of inventory spending accelerated in the March-April period, yet equally strong gains in business sales left the inventory-sales ratios in most sectors well below their year-end levels. Inventories of manufacturers advanced only slightly further in May, as shipments rose sizably.

The price situation is thoroughly unsatisfactory. Industrial wholesale prices recorded very large advances for the three months ended in May, and the consumer price data for May show sizable increases in virtually every product grouping. The most discouraging aspect in the May consumer price performance was the sharp acceleration in the rate of advance in nonfood commodity prices, which had shown a marked trend toward moderation earlier in the year. Price increases of the magnitude experienced recently are without precedent in other periods of economic slack since the Korean war.

PRODUCTION AND ORDERS

The Federal Reserve Board's index of industrial production registered a sizable gain of 0.7 percent in May (see Chart I). However, the recovery in production from the low point reached last November has been relatively mild, amounting to 3.6 percent. This increase is smaller than that recorded in the first six months of the recoveries from other recessions in the post-Korean war period. Six months after the February 1961 trough, for example, production had risen 7.6 percent—more than twice the recent rise. The comparison is even less favorable for the current production recovery when consideration is given to the major role that strike-related factors have played in the advance over the six months ended in May. In recent months, however, there have been in-



Note: The National Bureau of Economic Research has tentatively placed the peak and trough points of the recession at November 1969 and November 1970, respectively. Data for latest four months are subject to revision.

Source: Board of Governors of the Federal Reserve System.

creasing signs of a general strengthening of production outside the automobile and steel industries where output has been swollen, in the first case, by recovery from a strike and, in the second, by expectations of a strike.

Excluding the automobile and steel industries, industrial output has risen for three successive months by a total of 1.2 percent. In terms of market groupings, output of nonautomotive consumer products, which accounts for nearly one third of the overall production index, has been an area of pronounced strength. Since its November low, output of these goods has risen 3.2 percent, with almost all components recording substantial increases in recent months.

One factor aiding the May performance was a leveling in the long downtrend in both business and defense equipment production. The earlier decline in defense output, which directly accounts for about 3½ percent of overall industrial activity, has been so large that production is now down to about the level existing in the first half of 1965. This decline, of course, followed a climb in output of over 60 percent between the mid-1965 start of the Vietnam buildup and the mid-1968 peak in arms output. Production of equipment for business purposes, which accounts for about 12 percent of the production index, has also been a substantial factor in the weakness in overall activity in the past two years. In May the index of business equipment output was 15 percent below its October 1969 peak.

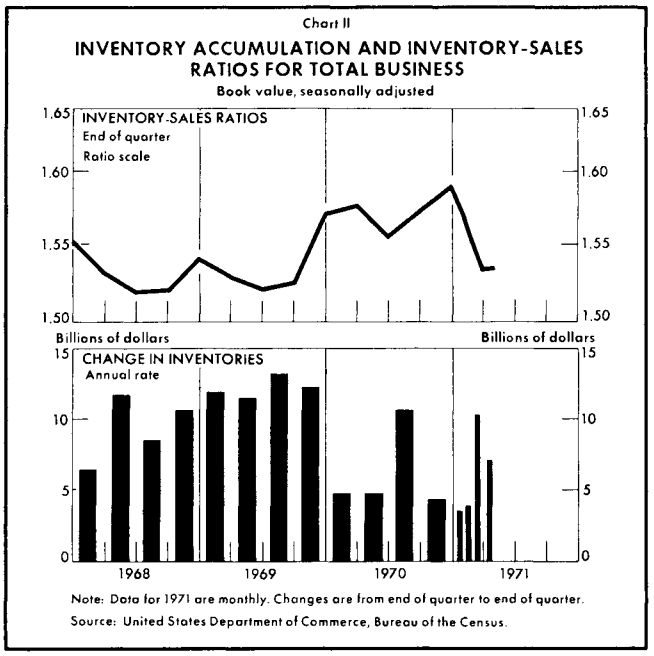
The May increase in output of motor vehicles and parts was about the same size as the overall advance, and that for steel a bit stronger. Output in the steel industry has climbed rapidly this year in response to inventory-stockpiling demands by steel users, who have been hedging against a possible strike when the steel industry's labor contract expires on July 31. According to industry spokesmen, however, the climb in production is about over. Stockpiling had been dampened this year by the sluggish nature of the economy and by the likelihood that a large number of mills would continue operating even if other firms were struck. Foreign steel has not been a major factor in curtailing the inventory buildup. Voluntary steel import quotas for 1971, although greater than in 1970, are substantially smaller than the amount imported in 1968, when the industry also went through an inventory-hedging cycle. Moreover, hedging by steel consumers may have peaked in June, rather than later this summer, as users attempted to acquire additional stocks in advance of further steel price increases.

The recent seesawing in new orders for durable goods sheds little light on the outlook for industrial production. In May, the volume of new orders received by manufacturers of durable goods rose by $0.4 billion. While the climb was broadly based, it followed two successive monthly declines including a very large drop in bookings during April. Thus, at the May rate of $31.1 billion, durables orders remained 2.5 percent below their February peak. Excluding the volatile transportation equipment group, however, orders in May were substantially above the February level.

BUSINESS INVENTORIES AND SALES

One of the most reassuring developments in the current outlook is that businessmen appear to have begun stepping up the rate of inventory accumulation. In April the book value of manufacturing and trade inventories rose at a seasonally adjusted annual rate of $7.2 billion (see Chart II). While below the $10.3 billion gain registered in March, the April rate was well above the average rate of only $4.1 billion during the previous five months. It is also noteworthy that about two thirds of the April rise in inventories occurred outside the automotive and steel industries. This contrasts sharply with the experience of the first quarter, when inventories held by other industries actually declined. Despite the relatively large overall rise in inventory spending in March and April, inventory-sales ratios were little changed, since business sales kept pace with additions to stocks. For example, the inventory-sales ratio for all manufacturing and trade businesses combined was 1.53 in April, little changed from the March level and decidedly below the position at the beginning of the year. Preliminary data for May, which so far are available for manufacturing only, indicate a further improvement in the inventory-sales ratio of that sector. Manufacturers added only $100 million to stocks in May, while shipments jumped by $700 million.

The moderate levels of the inventory-sales ratios suggest that improved sales are likely to be accompanied by stepped-up inventory accumulation which will, in turn, provide further impetus to the recovery. Earlier slowdowns in economic activity have each been characterized by a pronounced drop in inventory spending. When economic activity began to taper off, businesses first experienced a run-up of excess stocks as sales expectations failed to be realized. Businesses then responded to this situation by reducing their rate of inventory investment, and this in turn led to cutbacks in orders and production. A distinguishing element in the current cycle was that the rate of inventory spending was kept relatively low before the economic activity peaked late in 1969. In the third quarter of 1969, the quarter immediately preceding the period now tentatively designated by the National Bureau of



Economic Research as the peak of the expansion, inventory accumulation on a book value basis was running at a seasonally adjusted annual rate of $13 billion. Over the next two quarters, spending fell by $8 billion to a $5 billion rate. By comparison, in the fourth quarter 1966, which preceded the slowdown of 1967, inventory accumulation had climbed to an $18½ billion annual rate, and then in the following two quarters dropped by almost $16 billion to an annual rate of $2½ billion. The smaller size of the swing in the current cycle helped moderate the severity of the downturn.

RESIDENTIAL CONSTRUCTION

Activity in the residential construction sector continues to be vigorous. Spending for new private residential housing has climbed sharply this year. By May, outlays were running at a rate fully 15½ percent above the December level. The outlook for continued strength in this area remains firm. The volume of private housing starts rose to a seasonally adjusted annual rate of 1.93 million units in May, marking the third successive month in which starts have run at an annual rate of 1.9 million or higher. Thus, it now appears that the average number of starts in the half year ended in June will be well above the 1.8 million unit mark. This compares with an average of 1.6 million in the second half of 1970 and 1.3 million in the January-June period of last year. The recent starts data also show continuing strength in single-family units, which tend to have a higher unit value than do apartments. The building permits data for May indicate that further advances in housing starts are likely in the months ahead. Indeed, in May, the volume of newly issued building permits rose by a substantial 230,000 units on a seasonally adjusted annual rate basis. At the May level of 1.87 million units, the permits series far exceeded the previous record level for a single month. It might also be noted that there is still a fairly substantial backlog of building permits for residential structures which have not yet been started. This too suggests that the residential construction sector should continue to show gains in the months ahead.

PERSONAL INCOME AND EMPLOYMENT

In May, personal income rose by $6 billion, a gain of 8.6 percent in annual rate terms, equal to the average monthly increment in personal income so far this year. However, when allowance is made for special nonrecurring factors, the May rise was one of the two largest in the last twelve months. The overall advance in income was paced by a $3.9 billion rise in private wage and salary disbursements. Increased hours contributed to a substantial strengthening in the manufacturing sector, where income trends have been the weakest. Transfer payments continued to surge ahead in May, moving up by $1.1 billion. Last month the 10 percent increase in social security benefits, including retroactive payments to the first of the year, caused an unusually large spurt in these payments.

After improving for several months, nonagricultural employment in June suffered a puzzling setback which completely wiped out the gains of the previous three months. The overall decline totaled 300,000, with the number of persons on the payroll in manufacturing and trade establishments falling by about 100,000 each. Declines elsewhere were relatively small. The employment series that is based on a survey of households rather than firms indicated the June employment decline was accompanied by an unprecedented fall in the civilian labor force of 1 million persons. The labor force series has recently been volatile—growing by a total of 700,000 in the previous two months. Although a shrinkage in June seems reasonable, the size of the decline suggests that there may have been unusually difficult seasonal adjustment problems, particularly in the teen-age component. The fall in the labor force far outweighed the decline in employment,

and the seasonally adjusted unemployment rate thus fell from 6.2 percent in May to 5.6 percent in June, the lowest since last October.

RECENT PRICE DEVELOPMENTS

In May the upward trend in consumer prices accelerated sharply to a 6.7 percent seasonally adjusted annual rate of increase, the steepest one-month advance since February 1970. During the first four months of 1971, consumer price increases had moderated considerably relative to the experience of the two preceding years, although the degree of this moderation had been exaggerated by falling mortgage interest rates. In May, the decline in mortgage rates came to a virtual halt and, as a consequence, this factor did not exert any sizable further drag on the rise in services prices. Prior to May, the other major factor accounting for the more moderate rise in the overall consumer price index had been the very modest rise in nonfood commodity prices. In May, however, these prices soared at a seasonally adjusted annual rate of 8.3 percent. Sharply higher apparel and used car prices contributed significantly to the acceleration in nonfood commodity prices. The apparent deterioration of consumer prices, combined with the continued steep climb of industrial wholesale prices, suggests that little progress has been made in combating inflation.

A STUDY OF BANK CUSTOMERS IN CENTRAL NASSAU COUNTY

The Banking Studies Department of this Bank has published a report entitled "A Study of Bank Customers in Central Nassau County". This report by Patrick Page Kildoyle examines in detail the results of a 1970 survey of banking affiliations of business firms, households, and professional individuals in Central Nassau County, Long Island. The summary findings of this survey were presented in the November 1970 issue of this *Review*. A copy of the report may be obtained upon request from the Public Information Department, Federal Reserve Bank of New York, 33 Liberty Street, New York, N.Y. 10045.

The Business Situation

Business activity continues to recover at a rather slow pace in a highly inflationary atmosphere. Gross national product (GNP), after adjustment for price inflation, advanced at a seasonally adjusted annual rate of 3.7 percent in the second quarter, well below the growth rate registered at the similar stage of each of the three other post-Korean war business recoveries. The most recent monthly data, moreover, do not suggest any immediate change in the rate of recovery. In June, new orders for durable goods declined, industrial production remained virtually stable, and the rise in personal income (net of the increase in social security benefit payments) was smaller than in May. On the other hand, retail sales in June showed another sizable improvement according to the advance report, thus sustaining the strength that had emerged earlier in the quarter. Housing starts also rose further in June, and the continued high level of newly issued building permits implies that some additional upward movement in starts may be forthcoming. The underlying inventory situation seems conducive to a more expansionary pace of inventory spending, inasmuch as inventory-sales ratios in most sectors are at comfortable levels. However, the rundown of strike-hedge steel inventories is likely to limit the overall rate of inventory investment during the coming months.

Recent price developments continue to be thoroughly disappointing. Aside from some temporary moderating influences, there is little, if any, evidence of a slowing in the rate of inflation. In fact, during the most recent months, both consumer and wholesale industrial prices have been climbing more rapidly than they did earlier in the year. Cost pressures, moreover, remain very strong.

GROSS NATIONAL PRODUCT

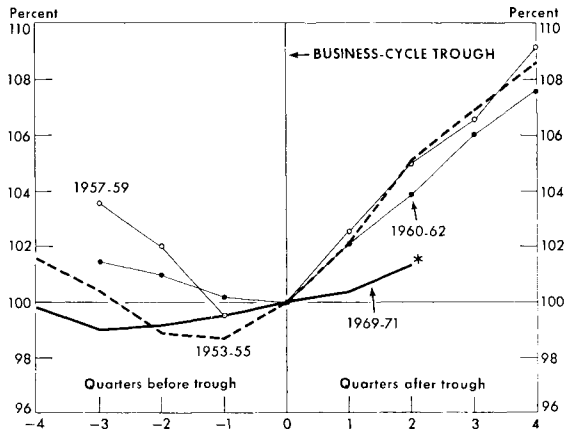
According to preliminary estimates by the Department of Commerce, the market value of the nation's output of goods and services rose by $19.7 billion during the second quarter to a seasonally adjusted annual rate of $1,040.5 billion. This gain was a shade higher than the average advance over the previous two quarters, the first of which was depressed by the automobile strike and the second considerably swollen by the subsequent rebound in auto production. Slightly more than half of the GNP growth in the April-June period took the form of higher prices, leaving the rise in real GNP at a 3.7 percent annual rate.

Since the fourth quarter of last year, which has been tentatively identified by the National Bureau of Economic Research as the trough quarter of the contraction, real output has grown at a 5.8 percent annual rate. However, the magnitude of the rise in real GNP over this period is biased upward because economic activity in the fourth quarter was, as noted above, temporarily depressed by the automobile strike. With certain allowances for the effects of the strike, the growth rate in real GNP since the cyclical trough has been about 1½ percent, or 3 percent in annual rate terms. Whatever the precise impact of the auto strike, it is clear that the upswing in real GNP in the two quarters since the cyclical trough has been very modest by comparison with the experience in the three other post-Korean war recovery periods. For example, over the two quarters following the troughs of the 1953-54 and the 1957-58 recessions, real GNP expanded by about 5 percent, or at an annual rate of 10 percent. Similarly, two quarters after the 1960-61 recession bottomed out, advances in real GNP amounted to a substantial 4 percent, or an 8 percent annual rate (see Chart I).

Recent movements in the Federal Reserve Board's index of industrial production (which has been substantially restructured and revised)[1] also attest to the slow tempo of recovery. After having risen 0.7 percent in April and again in May, it edged upward in June by only 0.1 percent. Despite the added thrust provided by strike-related gains in automobile and steel production, the overall rise in industrial output since last November has been a modest 4.3 percent, thus leaving the index in June 4.4 percent

[1]See "Industrial Production—Revised and New Measures", *Federal Reserve Bulletin* (July 1971), pages 551-76.

Chart I
REAL GROSS NATIONAL PRODUCT IN FOUR ECONOMIC CONTRACTIONS AND RECOVERIES



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).

* Adjusted at the Federal Reserve Bank of New York for the impact of the automobile strike.

Source: United States Department of Commerce.

below the pre-recession peak attained in September 1969. Sharply reduced levels of steel production will retard the growth of the overall index in the near future, as consumers work off their strike-hedge inventories of raw or semifinished materials.

During the second quarter, current-dollar final expenditures, i.e., GNP net of inventory investment, climbed $18.2 billion, about equal to the average of the two preceding quarters. This second-quarter rise in final expenditures was paced by a large $15.5 billion advance in consumer spending, as outlays for services and in particular nondurable goods posted considerable increases. The second-quarter gain of $2.4 billion in consumer spending on durables stemmed partly from an advance of $1.4 billion in outlays on automobiles and parts. The latter, in turn, reflected to a large extent the continued strength in sales of imported cars.

Over the first six months of 1971, sales of new domestic passenger cars were running at a seasonally adjusted annual rate of 8.3 million units (see Chart II). This figure, although well ahead of the total for 1970, was somewhat below the 8.5 million units averaged over 1968 and 1969. In contrast, total auto sales, at just under 10 million units during the first six months of this year, have surpassed the 1968-69 average of 9.6 million units. The difference is accounted for, of course, by the dramatic increase in sales of imported cars. Imports were selling at a 1.8 million unit annual rate in June and at a 1.7 million rate in the second quarter as a whole. This brought their share of the new car market to approximately 18 percent in June, the highest on record except for the strike-distorted final months of last year. Data for July show the rate of sales of domestic autos the same as during the first half of the year, with imports selling at a 1.6 million unit pace.

The large second-quarter rise in consumer spending recorded in the GNP accounts had been suggested by developments in retail sales over the quarter. The preliminary data for June—which could be sharply revised—indicate considerable further strengthening in retail purchasing at the end of the quarter. Indeed, these statistics show that total retail sales advanced by a hefty 1.6 percent in the month, with all major categories sharing in the gain. The June increase followed large upward revisions in the data for each of the three preceding months.

Even with the sizable advance in personal consumption outlays in the second quarter, consumers stepped up their rate of savings. As a consequence, the ratio of personal savings to disposable or after-tax income climbed to 8.3 percent from 8.1 percent.[2] Much, if not all, of this second-quarter rise can be traced to the increase in social security benefit payments that occurred in June. Since the new benefits were retroactive to January 1, the June payments included lump-sum payments for the earlier months of the year as well as the permanent increase in benefits. In the aggregate, this added about $5½ billion (at an annual rate) to second-quarter disposable income. However, the checks probably were received too late in the quarter to affect consumer spending appreciably, with the consequence that the savings rate increased significantly. Nevertheless, the rate was very high even aside from this factor. Indeed, over the six quarters ended in the April-June period, the savings rate averaged 8 percent in contrast to an average of about 6¼ percent over the post-Korean war period as a whole.

[2] Along with the preliminary GNP data for the second quarter, the Department of Commerce released its annual revisions of the GNP and related data for the last three years. In terms of the spending aggregates, most of the revisions were small. However, reflecting an upward revision in personal income and a downward revision in consumer spending, both the level of personal savings and the savings ratio were revised upward by significant amounts. For example, on the basis of the earlier estimates, the savings rate for 1970 was 7.3 percent whereas the revised data show the rate at 7.8 percent.

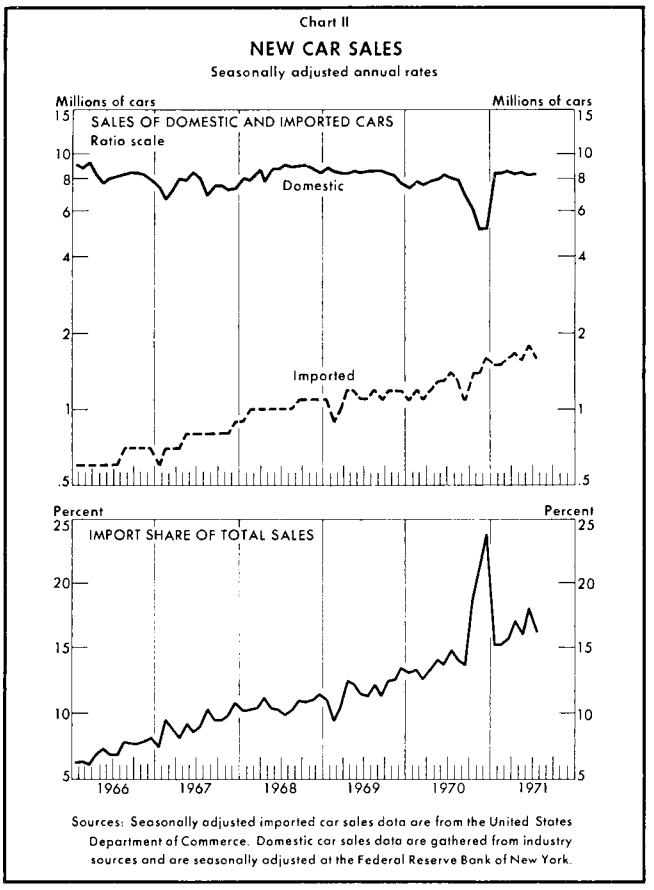
Spending on residential construction registered another strong advance in the second quarter, rising by $2.9 billion to a record seasonally adjusted annual rate of $39.3 billion; this was 37 percent above the recent low registered during the third quarter of 1970. The prospects for continued gains in home building seem good despite some firming of mortgage market conditions. In June, housing starts totaled 1.98 million units at a seasonally adjusted annual rate. This was the largest volume in any single month of this year and raised housing starts for the second quarter as a whole to a 1.95 million rate, the highest since the third quarter of 1950. Although building permits issued in June backed off somewhat from their very high May reading, the volume of permits for the second quarter as a whole points to the likelihood of a further increase in housing starts in coming months.

In contrast to the thrust provided by residential construction, business fixed investment in the second quarter advanced only at a slim $1.8 billion annual rate as a result of a $2.0 billion gain in outlays on producers' durable equipment and a small decline in outlays on structures. This served to confirm the rather sluggish outlook for capital spending suggested by various surveys, such as the 2.7 percent gain for 1971 indicated by the most recent Department of Commerce-Securities and Exchange Commission survey. Moreover, the already remote possibility that business fixed investment spending would strengthen in the coming months has been further diminished by other recent developments. As measured by the Federal Reserve Board's index of industrial production, output of business equipment slipped in June in continuation of a long decline dating from September 1969. The Federal Reserve also disclosed that manufacturing firms were operating at a low, seasonally adjusted 73.2 percent of their capacity during the April-June period, down from the 78 percent averaged over the first three quarters of 1970 which were relatively free from the effects of the automotive strike.

Inventory accumulation amounted to an estimated $4.7 billion (annual rate) in the second quarter. However, this figure is still quite preliminary, being based on partial returns for the months of April and May. Analysis of inventory movements in recent quarters is complicated by actual and potential labor disputes, but it appears that stockpiling in anticipation of a steel strike accounted for a sizable portion of the second-quarter accumulation. The runoff of these steel stocks in the coming months will, of course, act as a drag on overall inventory spending. Apart from the steel inventory situation, however, the inventory picture is good, with the inventory-sales ratios for all businesses and for most major sectors at comfortable levels. This contrasts with the situation at the turn of the year, when stocks were somewhat high relative to sales.

Government purchases of goods and services contributed $2 billion (annual rate) to the second-quarter GNP advance. Federal outlays dropped by $0.7 billion, as a $1.0 billion contraction in defense outlays was only partially offset by a small gain in the nondefense categories. Since peaking in the third quarter of 1969, Federal defense expenditures have fallen by an average of $1 billion per quarter, so that even a leveling-off would serve to bolster GNP growth. In this regard, there are some tentative indications that the prolonged contraction in defense outlays may have run its course. For example, based on the Federal Reserve Board's index of industrial production, defense and space equipment output increased for the second consecutive month in June, although it was still 29 percent below the peak reached in August 1968.

State and local government spending rose at an annual rate of $2.7 billion in the second quarter, as the overall advance was held down by an apparent decline in outlays on structures and capital-type goods. This latter drop was



Sources: Seasonally adjusted imported car sales data are from the United States Department of Commerce. Domestic car sales data are gathered from industry sources and are seasonally adjusted at the Federal Reserve Bank of New York.

probably a statistical fluke, since the very heavy volume of state and local borrowing in recent quarters is almost certainly providing an impetus to outlays on structures. Moreover, the Emergency Employment Act of 1971, which was signed into law during July, will increase Federal grants to state and local governments by an additional $1 billion during the current fiscal year. In turn, state and local spending will rise as these funds are used to provide public service jobs for the unemployed. Thus, state and local outlays could show larger gains over the coming quarters.

Net exports of goods and services, according to still incomplete data, plummeted from a $4.2 billion annual rate in the first quarter to a scant $0.1 billion in the April-June period as a result of a large spurt in imports and some slippage in exports. This sharp decline in net exports produced a $4.1 billion drag on the overall rise in GNP. The Commerce Department noted that imports of raw materials had increased, partly in anticipation of a steel strike. Observers point out that steel imports could subside substantially in the second half of this year, since foreign steel sellers may already have exhausted their voluntary quotas on 1971 shipments to the United States.

PRICES, WAGES, AND PRODUCTIVITY

Price developments during the second quarter reflect a combination of some major setbacks in the struggle against inflation and a few very tentative and isolated gains. On balance, there are virtually no signs of a significant lessening in the pace of inflation. The most comprehensive available measure of price movements, the GNP deflator, slowed to a 4.2 percent annual rate of increase in the second quarter, down from the 5.3 percent rate of the January-March period. This deceleration is an overstatement, however, since the first-quarter deflator was given a temporary boost by the Federal pay raise, which accounted for roughly 1 percentage point of the increase in that period. Moreover, since the deflator is a weighted average of many component price indexes, with the weights being determined by output in each current quarter, shifts in the composition of output can obscure underlying price trends. Both the final quarter of last year and the first period of 1971 were substantially affected by the huge swings in the durable consumption goods component, which exaggerated the pace of inflation in the fourth quarter and may have understated it in the first quarter. In the second quarter of 1971, a continuing shift in the composition of output toward relatively low-priced items may have resulted in a further overstatement of the extent to which inflation moderated. Using the output weights from the year 1958—the only full-year period for which such data are available—in an attempt to abstract from these compositional movements indicates that the annual rate of increase in the deflator during the April-June period was 5 percent rather than the 4.2 percent indicated by the current weights scheme. Although somewhat of an improvement from the 5.8 percent change (1958 weights) in the first quarter (after excluding the Federal pay raise), the 5 percent figure is not much lower than the 5½ percent advance averaged over the four quarters of last year. A similar deflator that uses weights from the fourth quarter of 1965 leads to essentially the same results.

Wholesale price changes must be interpreted as extremely discouraging. Movements in the overall index have been dominated by the erratic behavior of agricultural prices. Despite a July decrease, prices in the farm products, processed foods, and feeds category have advanced at a seasonally adjusted annual rate of 4.2 percent thus far this year, in contrast to their 1.2 percent decline during all of 1970. More significant, however, are the movements in prices of wholesale industrial commodities. These increased at an annual rate of 2.8 percent in the first quarter and 5.2 percent in the second quarter, and soared upward at an 8.4 percent rate in July. During 1970, such prices had risen by 3.6 percent.

Consumer prices made a poor showing in June, when the seasonally adjusted index spurted ahead at a 5.5 percent annual rate. This was somewhat below May's very high 6.7 percent upsurge, but considerably above the 3 percent advance registered over the first four months of this year. The Bureau of Labor Statistics' mortgage interest rate index declined for the sixth consecutive month in June and again retarded the rise in total consumer prices. Over the first half of 1971, the total consumer price index rose at a 4 percent annual rate, but without the benefit of declining mortgage rates it would have advanced at a rate of about 5 percent.

Movements in wages and salaries have provided little or no relief from inflationary pressures. Measured from a year earlier, the index of seasonally adjusted compensation per man-hour for the private nonfarm economy grew by a rapid 7.9 percent in the second quarter of 1971, the largest increase since the closing quarter of 1968. Output per man-hour rose by 3.5 percent from the second quarter of 1970 to the second quarter of 1971, a gain somewhat more modest than was experienced at similar stages of previous economic recoveries since the Korean war. As a consequence, labor costs per unit of output rose 4.2 percent, representing a definite slowdown from the peak year-to-year increase registered in the first quarter of 1970. Nevertheless, unit labor costs are still rising at an excep-

tionally rapid rate. This upward movement, moreover, contrasts with declines in parallel periods of previous cycles. By the second quarter after the cyclical trough, unit labor costs had fallen 2.7 percent following the 1953-54 recession, 0.4 percent after the 1957-58 contraction, and 1.2 percent subsequent to the 1960-61 downturn. These earlier declines resulted from somewhat more rapid rates of productivity growth than we have had this time and substantially smaller advances in compensation per man-hour.

The latest Bureau of Labor Statistics survey shows that the rate of increase in wages and benefits under major collective bargaining agreements was smaller during the first half of 1971 than for the full year 1970. The mean life-of-contract wage and benefit changes negotiated from January through June was 8.3 percent per year for all industries, in contrast to 1970's 9.1 percent. However, these data, which exclude possible cost-of-living wage increases, do not warrant the conclusion that there has been a slowdown in the pace of the advances. Manufacturing contracts signed during the first six months of this year provided for slightly larger average wage rate increases than last year. Moreover, very few construction labor agreements were included in the first six months' data, even though a large number normally occur during the April-June quarter. These construction settlements may well show up in the surveys covering the latter half of this year, giving an upward push to the figures for that period. In addition, the hefty settlements recently reached in primary metals, transportation, and communications will leave their imprint on the figures gathered for the third quarter of this year.

The rapid rise in labor costs has occurred despite the continuing generally soft condition of labor markets. A mixed picture emerges from the most recent data. According to the July survey of nonagricultural establishments, seasonally adjusted payroll employment declined by 200,000 workers, the second consecutive monthly decrease. Only about one fourth of this drop can be traced to the increase in the number of persons involved in work stoppages for the entire survey week. The July household survey, on the other hand, which counts striking workers as employed and further differs from the payroll survey in terms of coverage and seasonal adjustment techniques, indicated a rise in employment of 500,000. Since the seasonally adjusted labor force grew by 700,000 persons, the unemployment rate rose to 5.8 percent, up from the June figure of 5.6 percent which is believed to have been artificially depressed by seasonal adjustment problems.

The Business Situation

President Nixon's announcement on August 15 of a set of new economic policies for the country has apparently provided a significant and welcome boost to confidence in the nation's economic prospects. Such a gain in confidence will, if sustained, help greatly in bringing about the stronger business expansion the President hopes to achieve.

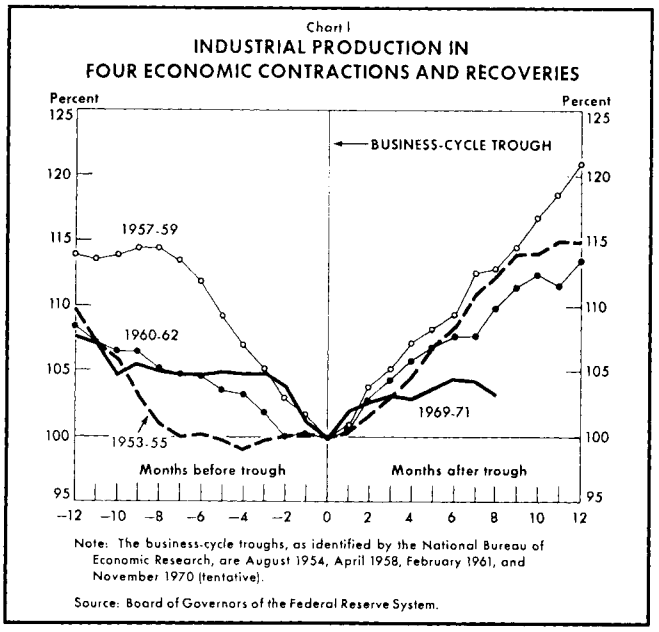
Prior to the President's announcement, business developments had continued to attest to the sluggish character of the recovery. In July, industrial production declined for the second consecutive month as labor contract deadlines and strikes precipitated decreases in the output of steel and other raw materials. Moreover, there was only a small increase in personal income after making allowance for a special factor that had caused an unusually large rise in June. In addition, the advance report on retail sales indicated a contraction in July. Furthermore, the unemployment rate in August, according to a survey in the second week of the month, rose from 5.8 percent to 6.1 percent, almost back to the recent 6.2 percent high of May. One area of economic strength was residential construction. Housing starts increased sharply in July to a figure that eclipsed the previous record, and building permits moved appreciably higher, suggesting that further gains in starts might be forthcoming.

It was against the background of generally slow economic expansion, accompanied by persistent inflation and mounting international financial pressures, that a basic change in the approach to achieving both economic growth and price stability was announced by President Nixon in mid-August. He used the powers available under the Economic Stabilization Act of 1970 to order a ninety-day freeze on wages and prices. A surcharge of 10 percent was imposed on a wide range of products imported by the United States. The convertibility of dollars into gold and other reserve assets was temporarily suspended. And several changes in taxes to stimulate a more rapid expansion in production and employment were recommended to the Congress. These recommendations included the elimination of the 7 percent excise tax on automobiles, retroactive to mid-August; the establishment for one year, also retroactively, of a 10 percent investment tax credit on new machinery and equipment, provided it is American made, to be followed by a permanent 5 percent credit; and the bringing forward to January 1972 of reductions in personal taxes previously scheduled to take effect at the beginning of 1973 through higher standard deductions and personal exemptions.

PRODUCTION, SHIPMENTS, AND INVENTORIES

The Federal Reserve Board's index of industrial production declined by 0.8 percent in July, the second consecutive monthly drop. Reduced output of raw materials —notably steel, copper, and coal—accounted for most of this latest decline, with labor disputes playing an important role. In the steel industry, production was depressed as users worked down the ample stocks of steel mill products that had been accumulated earlier in the year in anticipation of a strike. Moreover, a number of large producers began to bank their furnaces as the July 31 contract settlement deadline approached, thereby cutting further into steel output. A strike in the copper industry significantly curtailed the output of nonferrous metals, while the railroad labor dispute cut progressively into coal production because of the reduced availability of freight cars. Even apart from these special situations, industrial production was distinctly lackluster. The output of consumer goods showed essentially no change, while the output of both business and defense equipment declined.

The July decrease in production underscored the continued slow pace of the current economic recovery. In the eight months following November 1970, which has been tentatively designated by the National Bureau of Economic Research as the trough month of the 1969-70 recession, total industrial production rose only 3.3 percent even though output had been abnormally depressed in the trough month by the General Motors strike. In sharp contrast, the gains in industrial output over the first eight



months after the troughs of the three previous post-Korean war recoveries ranged from 10 to 13 percent (see Chart I). The limited data available for August do not indicate there was any step-up in production during the two weeks immediately before the President's new economic program was announced.

The policy changes initiated on August 15, however, will probably have a stimulating effect on economic activity, and perhaps most immediately on the sale and production of domestic automobiles. There may be a quickened pace of demand for automobiles in general in response to the proposed elimination of the excise tax. Sales may be additionally spurred by the temporary price freeze. Beyond this, the Administration's new economic policies will tend to reduce the prices of domestic automobiles relative to prices of imported cars. The latter are now bearing a temporary surcharge of 6.5 percent in addition to the regular 3.5 percent duty. (The surcharge is not the full 10 percent inasmuch as total import duties on any item may not exceed the ceiling prescribed by the Tariff Act of 1930, which for autos is 10 percent.) Upward movements in the exchange rates of foreign currencies will also tend to push up the prices of imported cars.

It does not seem likely, on the other hand, that the proposed 10 percent investment tax credit will generate sizable near-term gains in the output of business equipment. Most businessmen presumably will defer any firm decisions about undertaking additional new investments until the Congress, which reconvened on September 8, acts on the President's recommendation. Moreover, business spending on plant and equipment during the immediate future will certainly be tempered by the rather sizable amounts of excess capacity that currently exist in many industries. In the second quarter, the rate of capacity utilization in manufacturing was only 73 percent or well below the rates that prevailed in 1968, the last full year of economic expansion. The most recent Department of Commerce-Securities and Exchange Commission survey of plant and equipment spending intentions underscored the weakness in the near-term outlook for capital spending. This survey, which was completed too early to be influenced materially by the President's announcement, showed further cutbacks in plans for 1971, indicating a rise over 1970 of merely 2.2 percent, compared with the 4.3 percent increase that had been slated six months ago. However, the fact that the President's proposal calls for a 10 percent tax credit only until August 1972, and for a subsequent drop in the rate to 5 percent, provides a special incentive for businesses to undertake new capital spending programs within the period during which the higher tax credit will be in effect.

The most recent data on business inventories and sales continue to show improvement in the inventory-sales ratios for most sectors. Total manufacturing and trade sales increased in June by $1.4 billion, while inventories rose by a less than proportionate $0.4 billion.[1] Consequently, the inventory-sales ratio for all business fell to the lowest figure since mid-1966. Data for both shipments and inventories were somewhat distorted by the completion of billings in June on a large amount of aerospace equipment, which reduced reported inventories by over $500 million while increasing shipments by the same amount. However, even after adjusting for this special factor, there was a decline in the overall inventory-sales ratio. To be sure, these adjusted inventory data indicate

[1] The Department of Commerce has announced an upward re vision of $0.8 billion in the gross national product (GNP) estimat for the second quarter, reflecting in part the availability of inven tory spending data for the entire quarter. GNP for the quarter i now estimated at $1,041.3 billion on a seasonally adjusted annu rate basis, and the annual rate of real GNP growth is put at 4. percent rather than 3.7 percent. Net exports, however, are re ported as having dropped by $6.4 billion (seasonally adjusted ar nual rate) rather than $4.1 billion, but this downward revisio was more than offset by upward adjustments in other component including $0.8 billion in consumption spending, $0.9 billion i business fixed investment, and $1.0 billion in inventory accumul tion. Corporate profits before taxes are shown as rising during th quarter by $2.9 billion to $82.0 billion (seasonally adjusted ar nual rate).

a more expansionary pace of inventory spending than do the unadjusted data. After the adjustment, the book value of total business inventories shows a rise in June at an annual rate of $11.3 billion, more than double the gain suggested by the unadjusted figures. This more robust rate of inventory accumulation exceeded the increases registered in the three preceding months and was well ahead of the rate of spending in January and February, when relatively high inventory-sales ratios tended to dampen inventory investment.

In July, data for the manufacturing sector alone show there was a decline in inventories and a relatively greater decrease in sales. Consequently, the inventory-sales ratio rose. However, after adjusting the previous month's data for the unusually large aerospace equipment billings, the July decrease in inventories was larger than that in sales, and the inventory-sales ratio was virtually unchanged from the May and June levels.

New orders received by manufacturing industries in July advanced by $1.0 billion, owing entirely to a 3.3 percent rise in orders for durable goods. Heavier orders for defense goods, which tend to be especially large in the first month of the fiscal year, accounted for about $500 million of the overall advance. Sizable gains in new orders were also recorded in the automobile, aerospace, and machinery industries. Bookings for primary metals declined, however, largely as a result of the labor contract negotiations in the copper and rail industries. On balance, the pattern of new orders for manufacturers' goods has not yet displayed the clear and pervasive upward thrust that accompanied the other post-Korean war recoveries.

RESIDENTIAL CONSTRUCTION

Residential construction continued to be an economic bright spot in July, as total private housing starts jumped 11.2 percent to a seasonally adjusted annual rate of over 2.2 million units (see Chart II). At this rate, starts exceeded the previous record for a single month (in August 1950) by about 100,000 units. The strength of the current housing boom is underscored by the fact that the July figure was approximately 500,000 units above the peak level of starts recorded in January 1969 at the end of two full years of expansion in residential construction. Most of the July gain reflected an increased volume of multifamily units. However, single-family starts amounted to 1.2 million units, a relatively high figure by historical standards. The seasonally adjusted number of building permits also soared in July, reaching a record annual rate of almost 2.1 million units (see Chart II). This high level, together with a large backlog of permits for which actual construction activity has not yet begun, indicates that further gains in housing starts may well be forthcoming in the months ahead. The total supply of living units is being enlarged by continued strength in the demand for mobile homes. In June, factory shipments of mobile homes were running at a seasonally adjusted annual rate of 490,000 units, up dramatically from the 369,000 units shipped a year earlier.

The value of total new construction declined in July for the first time in twelve months. Industrial construction continued its generally downward movement from the high of October 1969, and commercial construction dropped sharply after a June surge. However, expenditures on both public construction and private residential construction showed strong gains. The near-term outlook for residential construction has been bolstered, moreover, by recent developments in the mortgage market that should have a favorable influence on the supply and cost of mortgage credit. Perhaps the most important of these developments was the sizable decline in interest rates on corporate bonds in the week following President Nixon's announcement of the wage-price freeze. If these declines are at least partially maintained, existing rates on new

Chart II
PRIVATE HOUSING STARTS AND BUILDING PERMITS
Seasonally adjusted annual rates

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

home mortgages will make the latter a more attractive investment for thrift institutions and other suppliers of mortgage credit. Furthermore, the Administration indicated in early August that it would seek to preserve the 7 percent ceiling on Government-underwritten mortgages by allowing the Government National Mortgage Association (GNMA) to purchase up to $2 billion in mortgages at a price not below 95 percent of par. In turn, GNMA will sell the mortgages at competitive rates in the secondary market while absorbing the interest cost differential by means of its special assistance fund. In another move taken in August to support the flow of funds to the mortgage market, the Federal Home Loan Bank Board reduced the liquidity requirements of member savings and loan associations from 7.5 percent to 7.0 percent.

INCOME, EMPLOYMENT, AND CONSUMER DEMAND

In July, personal income declined by $11.0 billion, falling to a seasonally adjusted annual rate of $859.1 billion. While this decrease reflected primarily the fact that personal income had been temporarily boosted in June by an increase in social security payments retroactive to the first of the year, the $2.3 billion rise that occurred in July after allowance for this special factor was still relatively small. The average monthly rise between December 1970 and May 1971 had been $5.8 billion. Emphasizing the underlying weakness of personal income in July, total wage and salary disbursements were essentially unchanged, and in manufacturing such disbursements actually declined by about $1.1 billion.

In August, the seasonally adjusted unemployment rate increased to 6.1 percent from the 5.8 percent registered in July, according to the Bureau of Labor Statistics survey of households, as a rise of 500,000 persons in the civilian labor force outpaced an advance in employment of 300,000 persons. This was the second consecutive monthly rise in unemployment and brought the rate almost back to the May high of 6.2 percent. Most of the increase was caused by rising unemployment among teen-age and adult males. The expansion in unemployment of adult men was attributable primarily to the curtailment of production in the steel industry. Nonfarm payroll employment remained essentially unchanged, with construction and manufacturing showing minor declines. Employment in manufacturing has been especially weak during the current recovery, declining slightly from its November 1970 level. In sharp contrast, during the three most recent previous recoveries the number of workers on manufacturing payrolls over the nine months following the business-cycle trough had risen an average of 4 percent.

Retail sales declined by 0.8 percent in July, according to the advance report. This drop, which was centered at nondurables outlets, followed a large increase in retail activity in June. However, the significance of this decline is questionable in view of the highly tenuous nature of the preliminary data. In every month of 1971 the advance report on retail sales has been revised upward, frequently by a significant amount. Whatever the final reading on the July data, the near-term course as well as the interpretation of the retail sales figures will in all probability be substantially affected by the new economic policies. With the savings rate at historically high levels, any bolstering of consumer confidence should have favorable ramifications for retail sales. Moreover, temporary increases might develop if purchases of domestic goods are accelerated on the expectation that prices will rise after the price freeze is terminated. As with other monthly indicators that are stated in dollar terms, however, changes in monthly retail sales throughout the price freeze period will be difficult to interpret relative to recent experience, during which sizable shares of the increases in dollar volume reflected simply advances in prices.

PRICE DEVELOPMENTS

The behavior of prices in the months immediately ahead will of course be dominated by the wage and price freeze. While it would be premature to speculate to what extent the freeze will affect the rate of inflation in the longer run, the large drop in long-term interest rates in the days following the President's August 15 announcement suggested that the freeze had the effect at least of temporarily reducing inflationary expectations. However, a lasting reduction in the rate of inflation will depend heavily upon decisions that are yet to be made for Phase Two, the time after the ninety-day freeze. The Cost of Living Council, which was appointed last month by the President, is currently considering various proposals for the achievement of price and wage stability over the longer run.

The highly inflationary background against which the freeze was initiated is illustrated by the recent performance of industrial wholesale prices. In August, the index of these prices rose at a seasonally adjusted annual rate of 6.4 percent, with almost all of the increase having taken place before the price freeze. This huge rise had been exceeded in July, when the index jumped at an annual rate of 8.4 percent, a record increase for the last fifteen years. Industrial prices during the first half of the year had advanced at an annual rate of 4.0 percent, a somewhat more rapid pace than for 1970 as a whole. In short,

despite almost two full years of distinctly sluggish activity in the industrial sector, prices had continued to advance at inflationary rates that were without modern precedent for a period characterized by such marked weakness in demand.

The overall performance of the consumer price index has been modestly better this year than that experienced in 1970. During the first half of the year, this improvement had partially reflected declining home mortgage interest rates. In July, on the other hand, there was a small increase in mortgage interest rates; nonetheless, the consumer price index rise slowed further to a 2.4 percent annual rate. This followed much larger increases in the two preceding months. Smaller advances in food, nonfood commodities, and to a less extent service prices all contributed to the July easing. This substantial slowing, however, might well have proved temporary with no price freeze, in view of the steep rise in wholesale industrial prices during the preceding several months. Increases in wholesale prices usually affect consumer prices after some lapse of time. The mid-August freeze may therefore have prevented the recent advances in wholesale prices from having as much repercussion on consumer prices as would otherwise have occurred.

TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS

The semiannual report on Treasury and Federal Reserve foreign exchange operations will appear in the October issue of this *Review*. The report is written by Charles A. Coombs, Senior Vice-President in charge of the Foreign function of the Federal Reserve Bank of New York and Special Manager of the System Open Market Account. It will cover the period March to September 1971. Exceptional conditions in the foreign exchange markets have forced postponement of publication.

The Business Situation

The Administration's new domestic economic policy to restrain wages and prices and to stimulate aggregate demand signaled a major change in the strategy of fighting the nation's twofold problem of inflation and high unemployment. Although it is far too early to assess the full impact of the new policy, it has helped to restore consumer and business confidence. The price freeze, combined with the proposed removal of the excise tax on automobiles, has been met by a rise in new car purchases. However, other fiscal steps designed to stimulate business activity will require more time to have their effect.

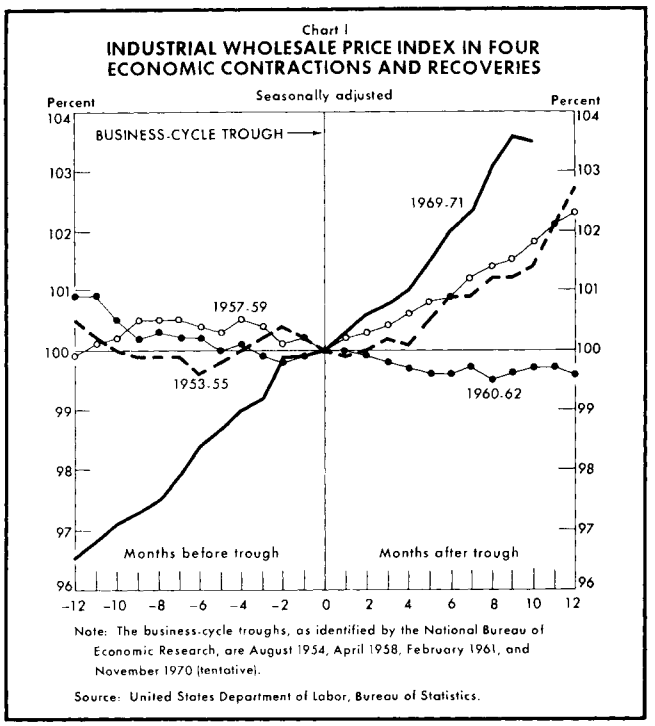
The initial impact of the price freeze is evident in the latest data on wholesale prices, which declined in September in sharp contrast to the rapid increases of other recent months. The persistence and severity of inflation in recent years make it clear, however, that wide public support of Phase Two policies is essential if cost and price pressures are to be substantially reduced.

THE CURRENT INFLATION

The wage-price freeze was necessitated by the failure of sluggish demand conditions to retard price increases. Between November 1969 and November 1970, the months tentatively designated by the National Bureau of Economic Research as the period of recession, industrial wholesale prices rose at a 3.6 percent seasonally adjusted annual rate—a rise nearly as fast as the gain in the preceding twelve months. In contrast, industrial prices had generally stabilized during previous post-Korean war downturns (see Chart I). Moreover, since the trough these prices have risen at an even more rapid rate of 4.8 percent. Indeed, data for July and August—which because of survey timing excluded virtually any effect of the freeze—indicated industrial wholesale prices averaged an alarming 7½ percent annual rate of advance. The continuation of sharp inflation in the face of a recession and the subsequent sluggish recovery appears to have resulted largely from the fact that the excess demand which kicked off the inflation in mid-1965 was reinforced, and eventually superseded, by widespread and severe cost pressures. At least as important, these pressures continued for so long that the expectations of further price rises became firmly entrenched and generated an inflationary force of their own. It should be noted, however, that there has been a high level of demand in some areas. Better than one fourth of the overall rise in the index of industrial wholesale prices (not adjusted for seasonal variation) through August was caused by the run-up in costs in the residential construction area, which has been expanding rapidly since its low in the first quarter of 1970. Prices of lumber and other construction materials rose at a 20 percent annual rate in the first eight months of 1971.

Under the freeze, the rise in industrial wholesale prices came to an abrupt halt in September. In fact, the index actually eased fractionally despite a few cases of increase. Most of these advances—such as that for iron and steel scrap—apparently resulted from the provision that firms had the choice of setting prices either at the level recorded on May 25, 1970 or at any level charged in the thirty days preceding the President's announcement. These small price increases were outweighed chiefly by a decline in wholesale automobile and truck prices, which reflected manufacturers' rebates to dealers for 1971 models. Agricultural prices dropped substantially in September, and thus the total wholesale price index fell at an annual rate of over 4 percent.

The behavior of consumer prices through August of this year was better than that of wholesale industrial prices. This performance, however, resulted largely from the rundown in mortgage interest rates that reflected Government subsidy programs and the general easing earlier in the year in the capital markets. In the first eight months of the year, the total consumer price index rose at a 3.9 percent seasonally adjusted annual rate, substantially less than the 5.5 percent rise in 1970 and the 6.1 percent in 1969. Excluding mortgage rates from the index, however, consumer prices rose at a 5.0 percent rate through July, much closer to the 1970 rate of advance. In August, the total index also rose at a 5.0 percent sea-



sonally adjusted annual rate, reflecting increases in a number of items. This survey was almost entirely completed before the imposition of the wage-price freeze on August 15. Even over the September-November period, however, the consumer price index is likely to show some increase since several items included in the series—such as sales and property taxes and some foods—are not covered by the freeze. Further, some of the components of the index are priced on a quarterly or semiannual basis. For these items, increases which took effect before August 15 will show up in the coming months.

CONSUMPTION AND INVESTMENT

The Administration's policies designed to promote the recovery of economic activity are aimed at stimulating consumption and investment. To concentrate the stimulus on the domestic economy, the President imposed a temporary surtax of up to 10 percent on dutiable imports. Another major method of stimulating consumption is the recommended removal of the 7 percent Federal excise tax on automobiles retroactive to August 15. The immediate impact of the President's recommendations was to boost sales of both domestically produced and foreign-made cars, since the surtax did not apply to those imports already in inventory or in transit at the time of the announcement. Aside from this short-run phenomenon, the stimulus should be largely confined to domestically produced automobiles, since the import surtax—which is 6½ percent on automobiles—will about cancel out the effect of the excise tax removal on prices of imported cars.

Led by increased sales at automotive outlets, retail sales in August advanced by 1.7 percent, according to the preliminary report. Sales of imports jumped to a 1.8 million unit seasonally adjusted annual rate in August, compared with the already high 1.6 million unit rate averaged over the first seven months of 1971. This surge, however, probably reflected a rush to avoid the surtax or higher prices that would result from realignments in exchange rates. In September the depletion of stocks on the West Coast that resulted from the dock strike there sharply reduced sales to a 1.3 million unit seasonally adjusted annual rate. Data for domestic cars indicate the sales pace rose to a 9½ million unit rate in September, compared with 8⅓ million in the first eight months of the year. Part of this increase in sales of domestic automobiles doubtless reflected attempts by some consumers to avoid future price increases.

In addition to the price freeze and the removal of the excise tax on automobiles, consumption may be stimulated by the boost to disposable income from the proposed acceleration to 1972 of the increases in the personal income tax exemption and the standard deduction that had been scheduled to take effect in 1973. Personal income growth has been moderate this year, aside from special factors such as the Federal Government pay raise in January, the increase in social security benefits in June, and the postal workers' pay raise in August.

The Administration's chief proposal to stimulate investment was the recommendation of an investment tax credit for business spending on domestically produced machinery and equipment, which has been a particularly weak area. The effects of the credit will in all likelihood be spread over a long period since there is often a long lead time between the initial planning stage and the start of actual production on major capital projects. In the near term, such factors as continued low capacity utilization and poor profits are likely to hold down spending on plant and equipment.

Among other components of investment, the outlook for residential construction continues buoyant while prospects for a pickup in inventory spending seem to have improved. The rebound in home building brought activity to record levels during the summer months. In both July and August, total private housing starts ran at a record 2.2 million unit seasonally adjusted annual rate, compared

with 1.9 million in the first half of 1971 and 1.5 million for all of 1970. The volume of building permits issued by local authorities also was very strong during the midsummer months, though the August figure was a bit below July's record pace. These trends, together with the continued availability of funds in the mortgage markets, suggest home building will continue at a rapid rate in the near term.

Inventory investment could also become an expansionary force in the months ahead. Inventory positions—as indicated by inventory-sales ratios—appear to be in the best shape in over two years. The inventory-sales ratio did rise in August in durables manufacturing, where the problem of excess stocks had been centered. However, the rise stemmed largely from a sharp decline in steel shipments, while the overhang of steel inventories that had been accumulated in anticipation of a steel strike was gradually being worked off. Aside from this factor, the inventories of most durables manufacturers appear to be in reasonable balance with sales.

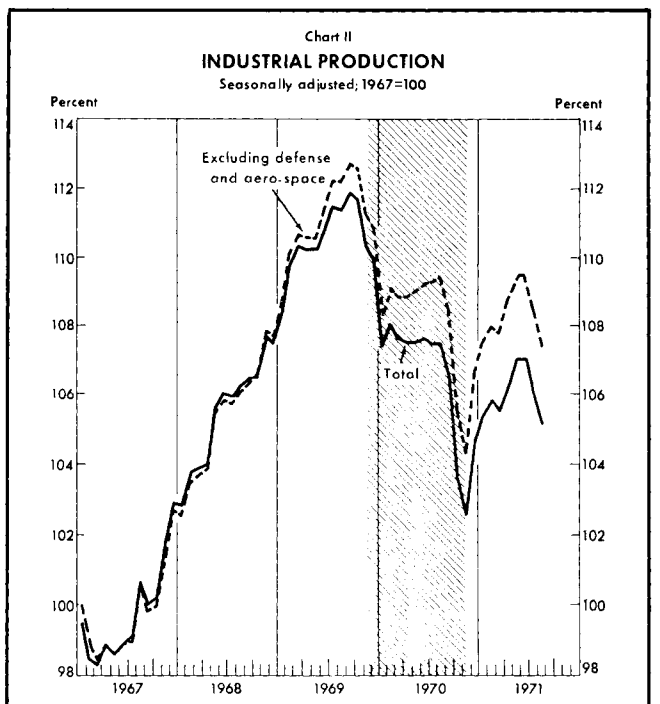
The realignment of inventories with sales resulted from businesses holding inventory accumulation to a moderate rate for the six quarters that ended in June. On a book-value basis, inventory accumulation in all of 1970 and in the first half of 1971 ran at an annual rate of about $6½ billion—substantially less than the $10 billion and $11 billion increases recorded in 1968 and 1969, respectively. Inventory spending at all levels of business remained quite moderate in July. August data, which are currently available for manufacturing only, indicate there was also no accumulation by manufacturers in that month. With the ratios of stocks to sales at relatively low levels, any improvement in the sales outlook can be expected to generate a step-up in the rate of accumulation.

PRODUCTION AND EMPLOYMENT

It is still too early for the improved prospects for demand to have had a measurable effect on production and employment activity, where the recovery has been feeble. Indeed, industrial production was about unchanged in June and declined in both July and August to a level only 2.4 percent above the November 1970 trough. Moreover, even this gain is overstated since the General Motors strike depressed November output. Nine months after the 1961 cyclical trough, industrial production had risen 11.4 percent, and over the corresponding period after the 1958 cyclical low the rise in output totaled 14.5 percent. While some special factors—notably in the defense and steel industries—have dampened production, the underlying sluggishness indicates an unusually weak recovery in aggregate demand and a startling leakage into imported goods. The business-cycle downturn coincided with a broad and prolonged cutback in the defense sector but, excluding this component, industrial production in August was still only 3.0 percent above the trough (see Chart II). The reduction in defense output was nevertheless pronounced, bringing production back down roughly to its level at the time of the Vietnam buildup—a decline in output of close to one third.

Another factor depressing the production index in July and August was the inventory situation in the steel industry. For the first half of 1971, steel output expanded rapidly in response to inventory stockpiling demand by users who feared a strike this summer. Production began to decline in July, as the firms banked furnaces in anticipation of a strike. In August steel output fell by one fourth, accounting for almost three quarters of the decline in the overall production index that month. Data on raw steel ingot production, however, suggest there was a substantial recovery in steel output in September.

The volume of new orders received by manufacturers



Note: The National Bureau of Economic Research has tentatively placed the peak and trough points of the recession at November 1969 and November 1970, respectively. Data for latest four months are subject to revision.

Source: Board of Governors of the Federal Reserve System.

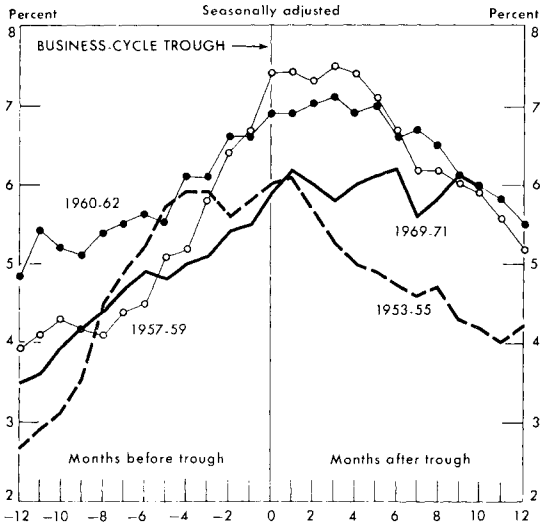
of durable goods through August did not imply much improvement in the outlook for production. While there have recently been some erratic movements, total bookings were still being received at about the same pace as in the first quarter.

Conditions in the labor markets have fared little better than industrial production. In contrast to past recoveries, the expansion of payroll employment since the trough has been weak. In the November 1970-September 1971 period, total nonfarm employment rose by 900,000 compared with a 1.4 million advance in the ten-month period following the trough of the 1960-61 recession. Payroll employment registered a strong rise in September which accounted for one third of this recent ten-month gain. Moreover, the September increase included a sizable advance in manufacturing employment, where the sluggishness has been centered. Even with last month's rise, manufacturing employment is still only 86,000 above November 1970, a level fully 1.7 million below its July 1969 peak.

There has been no improvement in the overall unemployment rate during the recovery, contrary to the behavior in other post-Korean war upturns (see Chart III). Thus, in September the unemployment rate was still 6.0 percent, the same as the average rate prevailing since the November 1970 trough. The failure of the unemployment rate to decline cyclically was chiefly the result of the small advance in employment, since labor force growth from the November trough has on balance been slow. This increase would have been even smaller but for the effect on the civilian labor force of the ongoing cutbacks in armed forces personnel. Since June, unusual problems of seasonal adjustment have distorted the underlying pattern of civilian labor force growth, but it does appear that the rate of expansion has picked up in the past two months.

Chart III

UNEMPLOYMENT RATES IN FOUR ECONOMIC CONTRACTIONS AND RECOVERIES



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 Statistics.

The Business Situation

Recent business statistics provide some favorable, though tentative, readings on the impact of the Administration's new economic policies. Price developments, particularly the September and October stability of industrial wholesale prices, attest to the effectiveness of the price freeze in that area. However, problems relating to survey techniques hampered efforts to assess the impact of the freeze on consumer prices, which recorded some increases in September. The rate of increase in compensation per man-hour in the private economy—the broadest measure of the behavior of wage costs—also slowed in the third quarter. The degree of this moderation was limited by the fact that these data only partially reflected developments during the wage freeze since it applied to only half the period.

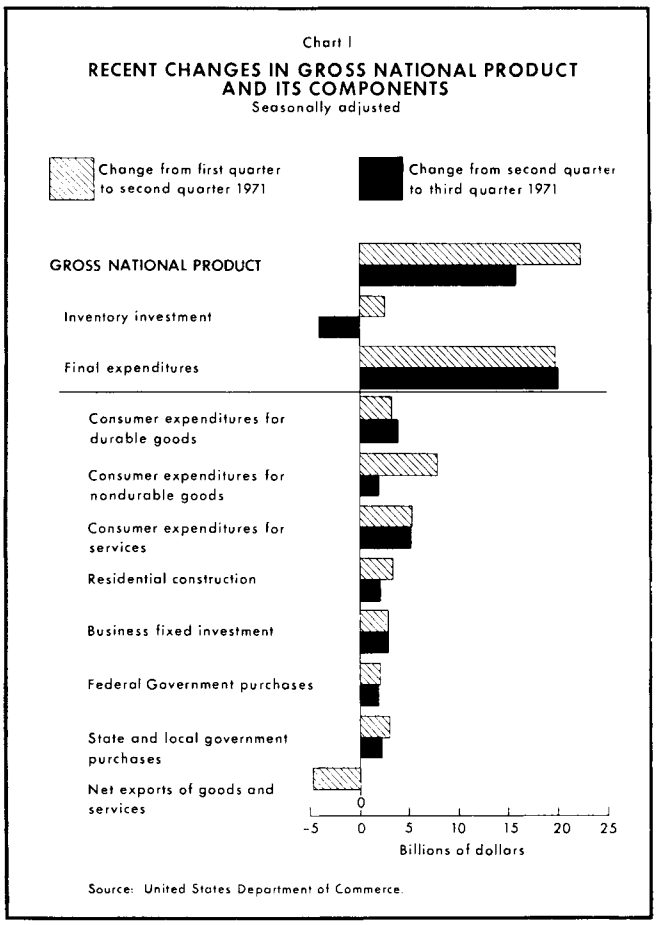
The price freeze and the probable elimination of the excise tax on automobiles have given rise to a dramatic upswing in purchases of domestically produced automobiles. However, the overall pace of the business recovery remains on the sluggish side, as indicated by the relatively modest rise in real gross national product (GNP) in the third quarter. Part of this sluggishness stemmed from the depressing influence that the liquidation of excess steel stocks had on production and inventory spending. The reductions in personal income taxes and the establishment of the 7 percent investment tax credit that are now being considered by the Congress should help to strengthen the business recovery. While the recovery in production and employment has been particularly weak overall, the decline in the unemployment rate for the two most recent months to 5.8 percent in October is encouraging.

GROSS NATIONAL PRODUCT IN THE THIRD QUARTER

The market value of the nation's output of goods and services rose by $15.9 billion (see Chart I) to a seasonally adjusted annual rate of $1,059.0 billion in the third quarter. This gain, which amounted to about 6 percent at an annual rate, followed the 9 percent rise that occurred in the second quarter. After adjustment for changes in the price level, the July-to-September increment in real GNP was approximately 3 percent in contrast to the 5 percent increase in real output posted in the preceding three-month period. Thus, the third-quarter performance of real GNP—like most other recent business statistics—continued to point to a relatively sluggish recovery. It should be noted, however, that a sizable portion of the data used in compiling these preliminary GNP estimates reflected events which occurred prior to the President's announcement of the new economic policies.

The slowing in the growth of nominal and real GNP was attributable to the reduced pace of inventory spending. According to preliminary estimates, inventory accumulation in the third quarter amounted to a modest $1.6 billion (annual rate), compared with the $5.7 billion rate in the April-June period, thus causing a $4 billion drag on the third-quarter rise in overall GNP. The pattern of inventory spending over the two most recent quarters was greatly distorted by the behavior of steel buying. In the April-June period, such spending was artificially increased by fears that the industry would be struck on August 1, whereas during the third quarter it was limited by the liquidation of a sizable part of those excess stocks. The drag on GNP arising from the inventory sector may be largely completed during the current quarter. In fact, with inventory-sales ratios in most sectors at comfortable levels, a more robust pace of inventory spending could become a major stimulus to the recovery once the overhang of excess steel inventories is worked off.

The third-quarter rise in final demand—i.e., GNP less inventory accumulation—amounted to $20 billion, a shade stronger than the increase posted over the April-June period. In real terms, final spending rose at a 4.7 percent annual rate. With the exception of the strike-distorted first quarter of 1971, this was the largest quarterly rise in real final demand in three years. The overall gain in final spending measured at prevailing prices was paced by relatively large increases in outlays for new residential



construction and by a strong gain in business fixed investment spending, while consumer spending registered a moderate increase.

Business fixed investment advanced by $2.7 billion in the July-September period. This strength was somewhat surprising in light of the weakness in plant and equipment spending that has been indicated in most of the recent Government and private surveys of investment plans. In fact, over the two most recent quarters, business fixed investment spending has risen at an annual rate of about 10 percent. A sizable fraction of the overall strength in such investment during the third quarter reflected a stepped-up pace of business purchases of automobiles and trucks and, to a far less extent, a higher level of spending for farm equipment. In part, the strong showing of business spending on autos and trucks may have been spurred by the price freeze, which provided an incentive to purchase these goods while the freeze was in effect to avoid future price increases. Similarly, the pending elimination of the excise tax on automobiles and small trucks may also have contributed to this higher level of spending.

Given the role that autos and trucks played in the third-quarter rise in business fixed investment, the strength in this spending component was not indicative of a turnaround in spending for new plant and equipment, where the general outlook remains weak because of the sizable amount of unutilized capacity that currently exists. The rate of capacity utilization in manufacturing actually decreased in the third quarter of 1971 and was below that which prevailed in the last quarter of 1970—the tentatively designated trough of the business cycle—despite the depressing impact of the auto strike on fourth-quarter production. The failure of the rate of capacity utilization to rise substantially by this stage of the business recovery contrasts sharply with the experience of the other post-Korean war recoveries (see Chart II). The current sizable volume of excess capacity will most likely dampen the near-term impact of the probable reestablishment of a 7 percent investment tax credit. Indeed, the recent McGraw-Hill survey of spending plans suggests that neither this credit nor the earlier liberalization of depreciation allowances has caused much step-up in investment plans.

Spending on residential construction continued its strong upward momentum in the third quarter, rising by $2 billion to a seasonally adjusted annual rate of $41.7 billion. While this was somewhat smaller than the gain posted in each of the previous three quarters, it brought the overall rise of home-building outlays since the third quarter of 1970 to a very sizable 45 percent. The prospects for continued strength in outlays for residential construction appear good. In particular, the substantial declines in long-term interest rates that have occurred since the President's August 15 speech should have a favorable impact on the availability and cost of mortgage credit.

Personal consumption expenditures rose $11.2 billion in the third quarter to a seasonally adjusted annual rate of $672.1 billion, about $5 billion less than the gain recorded in the previous quarter. All of this shortfall occurred in purchases of nondurable goods; in contrast, consumer spending on durables accelerated in the third quarter, rising by about $4 billion. With the exception of the strike-distorted first quarter of 1971, this was the largest quarterly gain since the third quarter of 1968. A sharp spurt in automobile buying after the President's August 15 speech was the major reason for the overall strength in durables spending during the quarter. Indeed, aided by the price freeze and by the probable elimination of the 7 percent excise tax, sales of domestically

produced cars rose markedly in the last half of the quarter, averaging a seasonally adjusted annual rate of better than 9 million units. Moreover, this surge continued into the current quarter, as sales of domestically produced cars ran at a seasonally adjusted annual rate of 10 million units in October. The decline in sales of imported cars from an annual rate of 1.8 million units in June to 1.3 million units in October apparently stemmed from the limited availability of imported vehicles that resulted from the longshoremen's strikes. Thus, the data which are currently available do not provide much guidance on the extent to which the import surtax and recent movements in exchange rates may have resulted in an increase in the demand for domestic cars at the expense of imports.

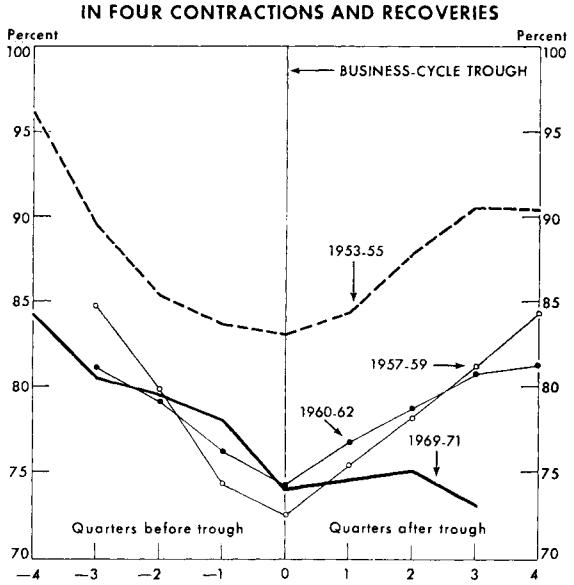
Despite the slower advance in consumption spending in the third quarter, the personal savings rate (the proportion of disposable income that is not spent) dropped by a relatively large 0.5 percentage point to 7.7 percent—a figure which is still very high by historical standards. The decline in the rate reflected the fact that the growth in personal income and disposable income diminished in the quarter. In turn, the slower growth in personal income occurred partly because the second-quarter rise had been inflated by a lump-sum retroactive social security benefit increase. The third-quarter gain in personal income may have also been limited by the wage freeze, although the precise impact of the freeze is difficult to ascertain. In the near term, however, disposable income will receive additional stimulus from the large military pay boost which will occur in the current quarter and from a series of personal tax reductions recommended by the President and now being considered by the Congress. This additional stimulus to disposable income may well help to trigger a still more expansionary pace of consumer spending.

Government purchases of goods and services rose by $4.2 billion in the third quarter, as Federal spending increased by $1.9 billion while outlays by state and local governments posted a gain of $2.3 billion. The July-September increment in state and local spending was relatively small by recent standards. This resulted from a slower rise in employee compensation—probably due in part to the wage freeze—and a weakening in expenditures on new construction.

Net exports of goods and services, according to preliminary and incomplete data, were in deficit by $0.5 billion for the second consecutive quarter. Although these data may prove to be particularly unreliable because of the distortions arising from dock strikes, the recent behavior of the trade account does show a significant rise in the rate at which the United States economy is consuming imported goods. Indeed, spurred in part by the automobile strike and the threat of a steel strike, imports have risen by $9.3 billion over the four quarters that ended in September 1971. In contrast, over the similar period terminating in September 1970, the rise in imports was only $4.2 billion.

Chart II

CAPACITY UTILIZATION IN MANUFACTURING IN FOUR CONTRACTIONS AND RECOVERIES



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: Board of Governors of the Federal Reserve System.

PRICES, PRODUCTIVITY, AND WAGES

During the third quarter, the implicit GNP deflator, which is the most comprehensive measure of price trends in the economy, rose at a 3.3 percent annual rate. This compares with the 4.0 percent rate of advance in the preceding quarter and represents the smallest rise since the second quarter of 1967. Since many of the underlying price data included in the deflator did not start to capture the effects of the freeze until September, comparatively little of the post-August 15 price developments show up in the average level of the deflator for the third quarter.

The deflator relies heavily, but not exclusively, on monthly wholesale and consumer price data. Although the freeze went into effect on August 15, the wholesale price data for that month describe almost entirely pre-freeze developments because of the timing of the survey

week. In September, wholesale prices actually eased on a seasonally adjusted basis, with prices of industrial commodities declining at a 1 percent annual rate after having risen at a 5 percent rate over the first eight months of 1971. In October, industrial prices again declined on a seasonally adjusted basis while agricultural prices rebounded. With the price freeze, however, normal seasonal adjustment procedures may be inappropriate. Thus, it is worth noting that without seasonal adjustment both the industrial and agricultural indexes were unchanged from their September levels.

The effects of the freeze on consumer prices were not so evident as in the wholesale area. The August consumer price index, which seems to have largely captured pre-freeze price movements, rose at a 5 percent rate. In contrast to the dramatic reversal of wholesale price movements during September, consumer prices rose at a still sizable 2.4 percent annual rate in that month. The September consumer price increases, which were not available in time to be incorporated into the third-quarter GNP deflator estimate, stemmed from a variety of sources. Since not all components in the consumer price index are priced each month, part of the September increase may have reflected higher prices on items which were included in the September survey but had actually risen in price prior to August 15. The September rise in the consumer index also included higher prices for certain items not covered by the freeze, such as college tuition, taxes, mortgage interest rates, and certain import prices.

In contrast to the deceleration observed in the rate of price increase for most of the major GNP components, the deflator for nonresidential structures soared at a 21 percent annual rate in the third quarter while that for residential structures climbed at a 14 percent rate. These two price groupings were responsible for about 1 percentage point of the 3.3 percent rise in the overall GNP deflator. While the structures deflators tend to be quite volatile on a quarterly basis, these third-quarter advances may be mirroring the rapid run-up over the first eight months of the year in construction labor costs and in building materials prices. In turn, the run-up in building materials prices may be primarily a result of the very rapid increases in demand and sustained high levels of activity in the area of residential construction. It is pressure for price increases of this type that will provide Phase Two with some of its greatest challenges.

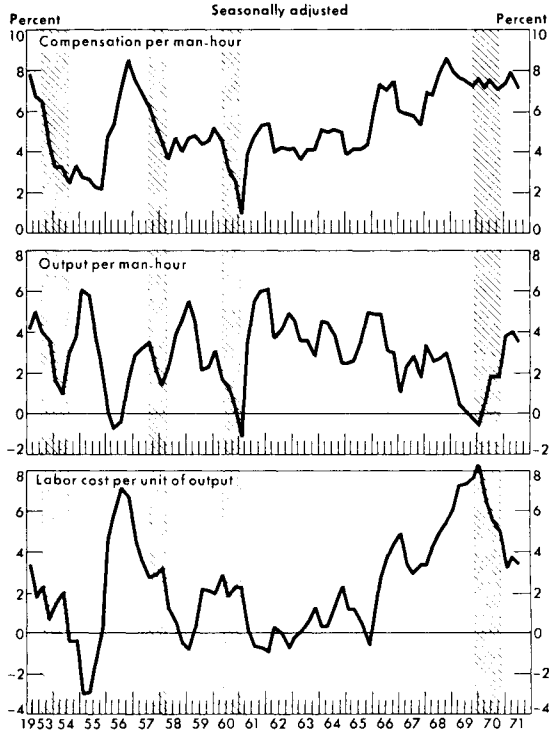
In previous business cycles, the behavior of unit labor costs was a major factor in achieving price stability (see Chart III). The cyclical pattern of declining unit labor costs chiefly resulted from the pickup in productivity growth

Chart III

LABOR COMPENSATION, PRODUCTIVITY, AND UNIT LABOR COST IN THE PRIVATE ECONOMY

CHANGE FROM FOUR QUARTERS EARLIER

Seasonally adjusted



Note: Shaded areas represent recession periods, according to the National Bureau of Economic Research chronology.

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

that accompanied the recovery in production. In the past year and a half, the rate of increase in unit labor costs has slowed considerably. In the third quarter, however, this trend was obscured by unusual developments. On the one hand, agricultural output increased sharply, mainly reflecting a bumper corn crop. On the other hand, manufacturing productivity actually fell, primarily because of cutbacks among highly productive steelworkers.

The third-quarter data on major collective bargaining settlements underscore the severity of the inflationary pressures plaguing the economy. Based on preliminary data, the mean negotiated increase in wages and benefits during the third quarter was about 8½ percent over the life of the contract—essentially the same as for the first half of the year and only slightly below the 1970 rate of 9 percent. Almost all the major contracts expiring in the third quarter had been negotiated by August 15.

The Business Situation

The progress of the economic recovery from last year's recession continues to be mixed. A year after the cyclical trough, tentatively placed in November 1970, production and employment remain sluggish by comparison with the gains experienced in earlier recovery periods. Indeed, the unemployment rate again inched up to 6.0 percent in November, as a rise in employment was swamped by a large increase in the civilian labor force. There have been some indications in recent months, however, that the momentum of the recovery may be quickening. The level of gross national product (GNP) in the third quarter has been revised upward by $1.8 billion from the preliminary estimate.[1] Retail sales rose strongly over recent months. Moreover, these gains were widely based and not confined to automotive demand, which had risen markedly in part as a result of the proposed elimination of the automobile excise tax. After allowance for the rundown of inventory stocks accumulated in anticipation of a midsummer steel strike, manufacturers' demand for inventories appears to have strengthened. Residential construction activity remains high and, according to recent surveys, plant and equipment spending is slated to accelerate somewhat over this year's lethargic pace.

The impact of the ninety-day price freeze, which ended on November 13, is most clearly apparent in the data on wholesale prices. Indeed, wholesale industrial prices actually declined slightly over the three months that ended in November. The response of consumer prices was less dramatic, although technical factors complicate an assessment of the precise impact of the freeze on consumer prices. Looking to the future, price developments will depend in part on the manner in which the wage and price norms that were announced in November are applied. The newly established Pay Board and Price Commission have announced goals of holding overall increases in wages and benefits to 5.5 percent and in prices to 2.5 percent annually. The achievement of these goals in 1972 would represent significant progress in the fight against inflation.

INDUSTRIAL PRODUCTION, ORDERS, AND INVENTORIES

The Federal Reserve Board's index of industrial production inched up a scant 0.2 percent in October on a seasonally adjusted basis. The increase in the overall index was held down by a sharp drop in the output of coal that resulted from the coal miners' strike. Indeed, excluding the impact of that strike, the rise in industrial output was relatively strong, as gains in production in other industries were broadly based. Output of steel, copper, industrial and commercial equipment, and consumer goods increased. On the other hand, output of defense equipment and some nondurable materials declined. By October, total industrial production had risen 3.6 percent above the November 1970 low but was still 0.8 percent below the 1971 high reached in June and 5.0 percent below the record peak attained in September 1969.

The flow of new orders received by durable goods manufacturers rose modestly in October on a seasonally adjusted basis. In fact, the series has been essentially flat all year. Although, in the past, movements in new orders have often foreshadowed changes in economic activity, recent developments may have affected the usefulness of this series as a forecasting tool. For example, confronted with the price freeze and the uncertainties surrounding Phase Two policies which were being formulated during

[1] The revised third-quarter estimate indicates that GNP increased by $17.7 billion to a seasonally adjusted annual rate of $1,060.8 billion. The rate of increase in the implicit GNP price deflator was revised downward slightly to an annual rate of 3.0 percent. The revised estimates indicate greater growth in real GNP—3.9 percent rather than 2.8 percent as originally reported. Among the major contributors to the upward revision in current-dollar GNP were residential construction and net exports. On the other hand, the initially reported small rise in business inventories was revised down by $0.5 billion to a $1.1 billion increase from the second quarter. The preliminary estimates of corporate profits, released along with the GNP revisions, reveal that after-tax corporate profits slipped $0.2 billion during the third quarter to $45.8 billion at a seasonally adjusted annual rate.

October, buyers and sellers may have been reluctant to make firm commitments. Nevertheless, new orders in the critical producers' capital goods sector rose in October to a record $6.9 billion, according to preliminary figures.

Recent movements in manufacturers' inventories have been dominated by the rundown in steel stocks built up by users in anticipation of a midsummer steel strike. Thus, manufacturers' inventories of materials and supplies—measured on a seasonally adjusted book-value basis—declined by nearly $0.5 billion between August and October, with much of this decline reflecting the liquidation of excess steel stocks. Apart from materials and supplies, however, inventory demand of manufacturers has strengthened. These firms' inventories of finished goods and goods in process increased by $1.0 billion between August and October. According to the results of a recent Government survey, moreover, manufacturers plan to expand their inventories further over the balance of the year. Increased inventory accumulation could well augment stronger final demand in spurring economic activity in coming months. This would be a major propellant for faster economic growth, since the sluggishness of inventory spending has been one of the most important factors in the slower than usual pace of the recovery.

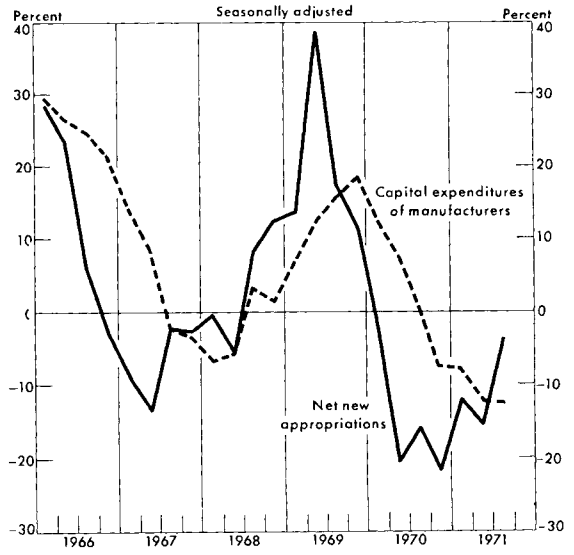
The strengthening in demand for inventories appears to have extended to wholesale and retail trade establishments as well. The book value of wholesale and retail trade inventories rose by a substantial $0.6 billion in September (the latest month for which data are available). During the third quarter, total trade inventories increased at a seasonally adjusted rate of $1.9 billion, up about $0.4 billion from the previous quarter. At the same time, inventories at retail automotive outlets declined slightly. For the most part the accumulations were about in line with sales, and inventory-sales ratios remained at comfortable levels.

PLANNED INVESTMENT SPENDING

According to several surveys taken after President Nixon outlined the new economic program on August 15, businesses plan to step up their fixed investment outlays in 1972. In a survey taken jointly by the Department of Commerce and the Securities and Exchange Commission in October and November, plant and equipment expenditures during the first half of 1972 were projected to rise 9.1 percent above what they had been in the comparable period of 1971. This estimated increase is consistent with the results of private surveys covering the entire year. The McGraw-Hill survey reported a 7 percent planned rise in plant and equipment expenditures during the upcoming year, slightly exceeding the 5 percent increase in capital goods' prices anticipated by the respondents to the survey. In comparison, the results of the earlier Lionel D. Edie and Co. survey indicated that businesses plan to spend 9 percent more on fixed investment goods while expecting capital goods' prices to rise 4.5 percent.

Although there are differences among the survey results in some details, the surveys are in broad agreement over the projected course of manufacturers' expenditures for plant and equipment. Whereas this spending component has been distinctly sluggish in 1970 and 1971, all three surveys foresee a substantial rise during the next few months. Of course, how much of this planned spending actually materializes will depend on how closely unfolding economic developments match current business projections. One early sign that a pickup in manufacturers' capital spending may be in the offing is the third-quarter turnabout in capital appropriations made by manufacturers (see Chart I). After falling in the previous quarter, net new appropriations increased some 14 percent in the third quarter according to a Conference Board survey. While the volatility of this series argues against attaching too much significance to short-run movements, the increase is consistent with the outlook for manufacturers' plant and equipment spending provided in the other surveys.

Chart I
MANUFACTURERS' EXPENDITURES AND APPROPRIATIONS FOR NEW PLANT AND EQUIPMENT
CHANGE FROM FOUR QUARTERS EARLIER
Seasonally adjusted



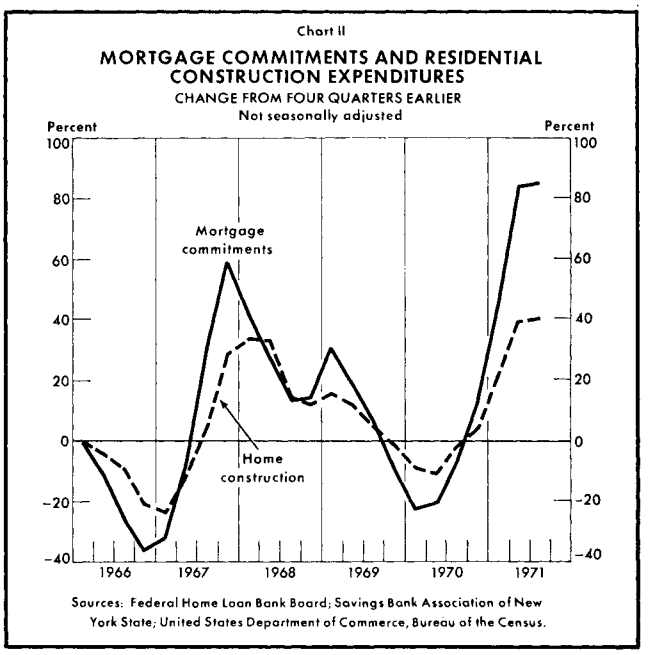
Source: The Conference Board, Inc.

RESIDENTIAL CONSTRUCTION

Residential construction activity has continued to be a source of considerable economic strength. After dipping in September, housing starts in October again edged above the 2 million mark on a seasonally adjusted annual rate basis—a shade below the record third-quarter average of 2.1 million units. At the same time, newly issued building permits jumped nearly 17 percent in October to a seasonally adjusted annual rate of 2.2 million units, an all-time record. Since newly issued permits again exceeded the number of housing starts, the backlog of units yet to be begun rose in October, continuing its almost steady growth of the past year or so.

The course of residential home building during coming months will depend to some extent on developments in the mortgage market. Since in most instances mortgage commitments must be secured before construction financing can be arranged, the commitments series serves as an advance indicator of construction activity (see Chart II). In the third quarter, outstanding commitments of savings and loan associations and mutual savings banks had risen to record levels on a nonseasonally adjusted basis. Moreover, according to most indicators, conditions in the mortgage market have eased since then. It is true that the average interest cost of conventional mortgages edged higher in September before leveling off in October. However, these data are based on mortgage closings and thus reflect market conditions as much as several months earlier when the commitments were made. The more sensitive secondary market yields of Federal Housing Administration-insured loans declined in both September and October. A major factor underlying this easing in the mortgage market appears to have been the relatively large declines in interest rates on corporate bonds and United States Government securities. For example, the interest rate spread of conventional mortgages over Government securities with a maturity of ten years or more increased almost 60 basis points between June and October, while the spread between secondary FHA mortgages and long-term Government securities rose 34 basis points. Earlier in the year, when interest rates on these instruments were high relative to those on mortgages, savings and loan associations and mutual savings banks had used portions of their sizable savings inflows to acquire bonds and, in particular, to rebuild their liquidity positions. Recently, however, they have begun to channel proportionately more of their inflows to the mortgage market.

The expanded presence of the Federal Government in the private housing sector has contributed importantly to the 1971 housing boom. During the current year, the number of private housing starts receiving either a direct or indirect Federal subsidy is estimated at about ½ million units. It is unlikely that the number of subsidized starts will decline next year, especially in view of the Government's strong commitment to upgrade and enlarge the stock of residential housing.



INCOME, CONSUMPTION, AND EMPLOYMENT

Compared with the $5.1 billion monthly average increase in personal income so far this year, the $0.8 billion rise in October was minuscule. The increase was more than accounted for by a $1.3 billion increment in wage and salary disbursements—this too being well below the average growth of previous months. With wages frozen and payroll employment practically unchanged in October, the increase in wage and salary disbursements probably stemmed largely from the longer workweek and increased overtime during the month.

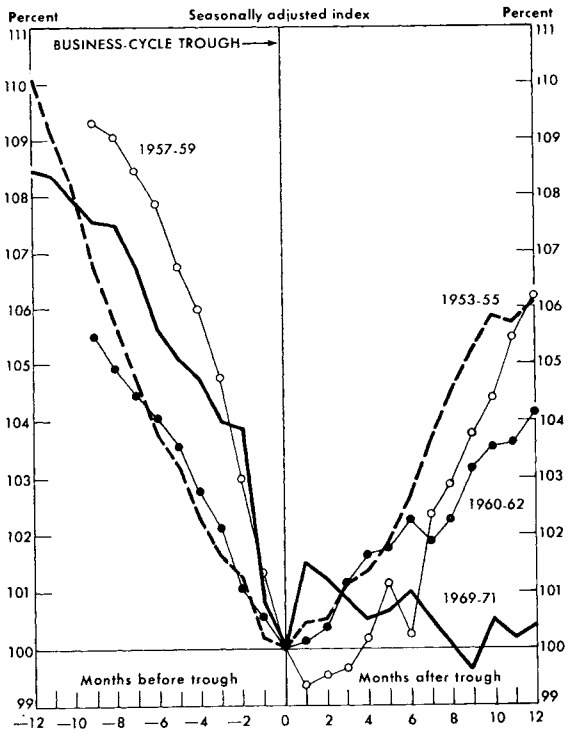
Recent retail sales data support the view that consumers have become somewhat less hesitant. During the five months that ended in October, nonautomotive retail sales increased at a seasonally adjusted annual rate of 8.3 percent. In comparison, over the first five months of the year, nonautomotive sales had grown at an annual rate of only 3.5 percent. In view of the slowing in the rate of increase of consumer goods prices, the recent accelerated

growth in nonautomotive retail sales is all the more significant. After surging dramatically in August and September, the automotive component of retail sales fell slightly in October, according to preliminary estimates. This decline may reflect seasonal adjustment difficulties associated with the price freeze, inasmuch as unit sales of new domestically produced passenger cars were reported to have risen almost 8 percent in October. During the three months ended in November, these sales were running at a seasonally adjusted annual rate of 9.8 million units, an increase of nearly 17 percent over average sales in the earlier months of 1971. Another indication of growing confidence on the part of consumers can be seen in their willingness to increase their indebtedness. The average monthly increase in consumer credit over the five-month period ended in October was nearly double that of the first five months of the year.

To some extent, the apparent shoring-up of consumers' confidence may be anchored in labor market conditions, which have begun to show some—admittedly scattered—improvements during recent months. After being virtually unchanged during the first six months of 1971, civilian employment posted a substantial gain of 520,000 on average in the third quarter, matched by an almost equal gain in the first two months of the current quarter. At the same time, however, this employment growth has been largely counterbalanced by an unusually big rise in the civilian labor force, leaving the unemployment rate hovering at 6.0 percent.

Some tentative improvements in labor market conditions can also be seen in the recent payroll survey data. After remaining virtually flat during the first eight months of the year, nonagricultural payroll employment increased about 390,000 on a seasonally adjusted basis between August and November. The extent of the advance was held down by the coal miners' and East and Gulf Coast dock workers' strikes, which were still in progress at the time of the November survey. In the manufacturing sector, the number of workers employed rose by 130,000 from August to November. Part of this gain was accounted for by the return of some steelworkers who had been laid off in August after the threatened steel strike was averted. Taking a longer perspective, the relatively slow pace of the recovery from last year's recession is clearly evident in manufacturing employment. During the year after the tentatively identified recession trough of November 1970, employment in manufacturing increased by only 0.4 percent (see Chart III). In contrast, such employment had posted gains ranging from 4.1 percent to 6.2 percent in the three earlier post-Korean war recoveries.

Chart III
MANUFACTURING EMPLOYMENT IN FOUR CONTRACTIONS AND RECOVERIES



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.

PRICE DEVELOPMENTS

The special circumstances surrounding the ninety-day price freeze that ended on November 13 have made recent movements in the consumer price index difficult to assess. For example, prices of some commodities and services were exempt from the freeze. Moreover, some items covered in the consumer price index are priced less frequently than monthly so that numerous price changes are reflected in the index with a lag. Even the practice of seasonal adjustment may produce misleading results when the customary seasonal variations are not fully permitted. With this in mind, the latest available data indicate that consumer prices rose at a seasonally adjusted annual rate of 1.6 percent in October, the smallest advance since April 1967. On an unadjusted basis the index rose at a 2 percent annual rate in October, the same as in the preceding month. The rate of increase in prices of nonfood commodities (not seasonally adjusted) was a large 5.1 percent

in October, the same as in the preceding month, and primarily reflected higher prices for apparel and new cars, including imports.

The price freeze apparently had a much greater effect on wholesale prices than on consumer prices. After rising sharply over the first eight months of 1971, wholesale prices actually declined slightly between August and November. While prices of agricultural products which were not subject to the freeze fluctuated widely, industrial wholesale prices generally edged lower. These prices fell at a seasonally adjusted annual rate of 1.3 percent between August and November, following their large increase at an annual rate of 5.0 percent earlier in the year. On an unadjusted basis, industrial wholesale prices fell at an annual rate of 0.7 percent between August and November.

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The Business Situation

The pace of the economic expansion has shown some modest signs of quickening in recent months, although the overall progress of the recovery remains uneven. To a considerable extent, the stepped-up rate of activity has been grounded in the greater volume of retail sales. Prospective increases in personal disposable incomes—stemming in part from the reductions in tax liabilities in 1972 that were enacted on December 10—should provide further impetus to consumption expenditures and, eventually, to other areas of the economy as well. Beyond that, the agreement among the Group of Ten industrial nations (for details, see page 7) should stimulate production by relieving some of the uncertainties in international trade. New orders for durable goods posted a sizable gain in November, and the backlog of unfilled orders rose by the largest amount in almost a year. Moreover, the underlying demand for inventories also appears to have increased somewhat during recent months. The unemployment rate, on the other hand, edged up slightly to 6.1 percent in December.

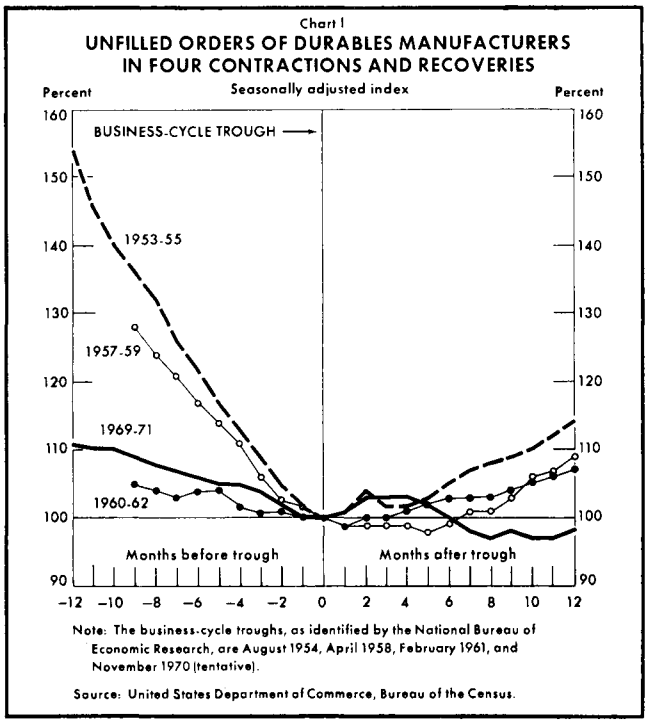
Most of the available data on prices and wages continue to reflect the influence of the ninety-day freeze, which ended November 13. Between August and November, the increase in prices of nonfood consumer commodities halted while industrial wholesale prices actually fell slightly. At the same time, the advance of workers' hourly wage rates slowed dramatically from the sizable rises posted earlier in 1971. Under Phase Two, subsequent developments will reflect the guidelines and decisions of the Price Commission and the Pay Board. However, rather large recorded rises in wages and prices are to be expected in December and January, as some increases delayed by the freeze are superimposed upon those that would have normally occurred.

PRODUCTION, ORDERS, AND INVENTORIES

The Federal Reserve Board's index of industrial production rose by a substantial 0.8 percent in November. Although about one quarter of the rise in output during November was attributable to the settlement of the coal miners' strike, the rest of the advance was widely distributed among the major industrial and market groupings, with large increases occurring in the output of consumer nondurables and business equipment. Despite the expansion in the production of business equipment, the output of durables manufacturing industries overall showed very little change in November and remained almost a full percentage point below its recent high attained in May 1971. Indeed, the absence of any appreciable strengthening in durables production since November 1970, which has tentatively been dated by the National Bureau of Economic Research as the cyclical trough, has been a major factor underlying the slow pace of the current economic recovery.

In contrast to the small rise in durables production in November, new orders for durable goods jumped 4.3 percent on a seasonally adjusted basis, after having risen by a much smaller amount in the previous month. While the volatility of this series argues against attaching a great deal of significance to this most recent gain, special factors may have obscured any improvement in the underlying demand for durable goods during earlier months. For example, the November spurt in new orders may have stemmed partly from the lifting of the price freeze. During the time that the freeze was in effect, some buyers and sellers may have been reluctant to enter into firm agreements until a clearer picture of the Phase Two wage and price policies had emerged. Another factor that has tended to depress new orders during recent months has been the rundown in steel stocks that had been built up by users in anticipation of a midsummer steel strike. With the sharp November advance, durables orders exceeded shipments and the backlog of unfilled orders swelled by $400 million on a seasonally adjusted basis, the largest gain since January 1971.

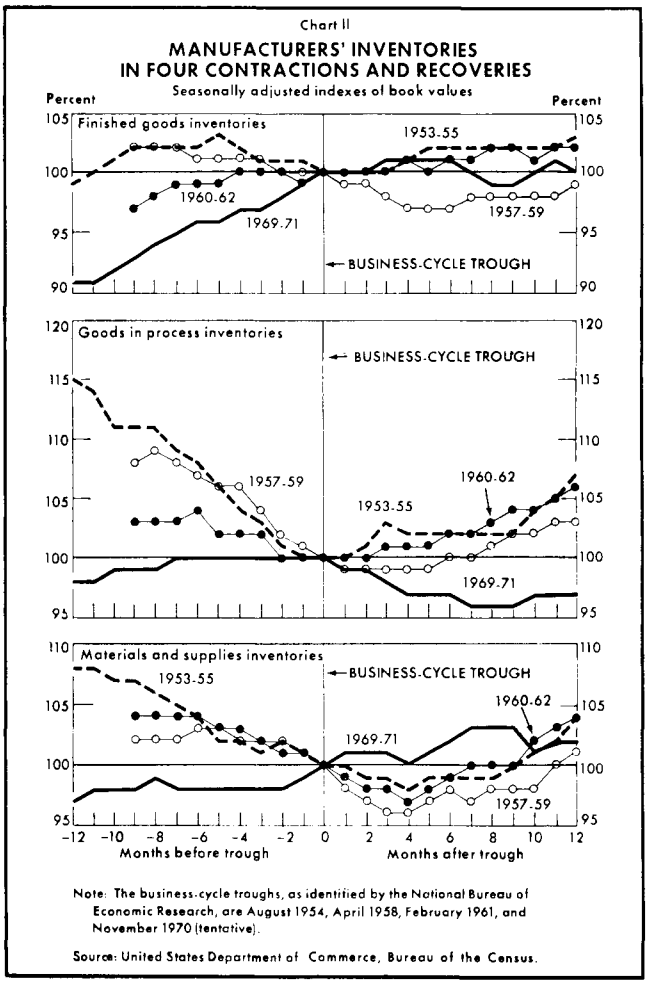
Taking a somewhat longer perspective, the growth in new orders for durable manufactured goods was relatively modest and quite uneven in the twelve months after the cyclical trough. While durables orders were almost 18 percent higher in November 1971 than they had been one year earlier, this increase was in fact smaller than the



gains experienced during comparable periods of recovery from any of the three earlier post-Korean war recessions, when the increases ranged from 20 percent to nearly 50 percent. Indeed, the weakness of the current recovery is even more pronounced than this comparison suggests, since the level of orders in November 1970 was depressed by the General Motors strike, then in its third month. The backlog of unfilled orders for durable goods rose slightly during the opening months of 1971 but retreated thereafter. Despite the advance in November, unfilled durables orders were still 2.3 percent below the level of twelve months earlier and were fully 12.4 percent below the peak attained in July 1969. In comparison, in the three previous post-Korean war recoveries the orders backlog had grown substantially in the year following the cyclical trough (see Chart I).

The relatively cautious scale of inventory investment spending by manufacturers has contributed importantly to the slow pace of the current economic recovery, primarily reflecting the outright declines in the stock of goods in process (see Chart II). In previous recoveries, these inventories had registered fairly strong growth; in the current recovery, however, they continued to fall long after the cyclical trough had been passed. These declines have to some extent been related to the failure of unfilled orders to begin a sustained and pervasive rise. The stock of goods in process was gradually diminished as durable goods continued to be finished and shipped at a faster rate than they were being replaced by new orders. In contrast, the accumulation of materials and supplies, though dominated by the buildup and subsequent rundown of steel stockpiles, does not appear to have been otherwise very different from previous recovery periods. Similarly, the behavior of finished goods inventories has been roughly in line with the performance in earlier comparable periods.

Following the outright declines in earlier months, manufacturers have begun to add to their inventories in recent months. Between August and November, the stock of finished goods inventories, measured on a seasonally adjusted book-value basis, increased by about $400 million, while that of goods in process swelled by a bit more than $630



million. Each of these components had fallen quite sharply during the previous three-month period. Reflecting the rundown of the excess steel inventories, the book value of materials and supplies declined by almost $550 million between July and September. However, it appears that this inventory correction may have run its course, inasmuch as the stock rose slightly in October and was virtually unchanged in November. Indeed, the volume of new steel orders increased in November. Taken together, these data suggest that inventory investment spending by manufacturers had begun to strengthen in the closing months of last year.

PERSONAL INCOME AND RETAIL SALES

Personal income posted a modest increase of $3.5 billion in November, rising to a seasonally adjusted annual rate of $876.0 billion. Virtually all of this growth in personal income was accounted for by a $3.1 billion increase in wage and salary disbursements, one third of which was, in turn, attributable to the military pay raise that took effect at midmonth. The small size of the November expansion in private wage and salary disbursements was, in part, indicative of the limited increases in employment and hours worked that occurred during the month. The wage freeze was an additional factor, however, as a sizable portion of the data used to estimate personal income was collected before the freeze had been lifted. Over the three-month period that ended in November, the average monthly gain in wage and salary disbursements was only $1.7 billion.

The relatively small increase in personal income in recent months has not had a dampening impact on consumer spending. On the contrary, buoyed by an apparent improvement in consumer confidence as well as by consumers' anticipations of price hikes after the freeze, retail sales advanced at a seasonally adjusted annual rate of 18 percent over the four months that ended in November. While part of this advance resulted from the widely publicized surge in automobile sales, the gains in retail buying were broadly based, with sales of both nondurables and nonautomotive durables growing appreciably. Over the same four-month period, nondurable retail sales increased at a 11 percent annual rate while nonautomotive durables sales soared 22 percent. These growth rates were more than double those experienced in the first half of 1971. Moreover, since this sizable expansion in current-dollar retail sales occurred over the period in which the price freeze was still in effect, rising prices accounted for a much smaller share of the overall advance in the dollar volume of sales than was the case earlier in the year.

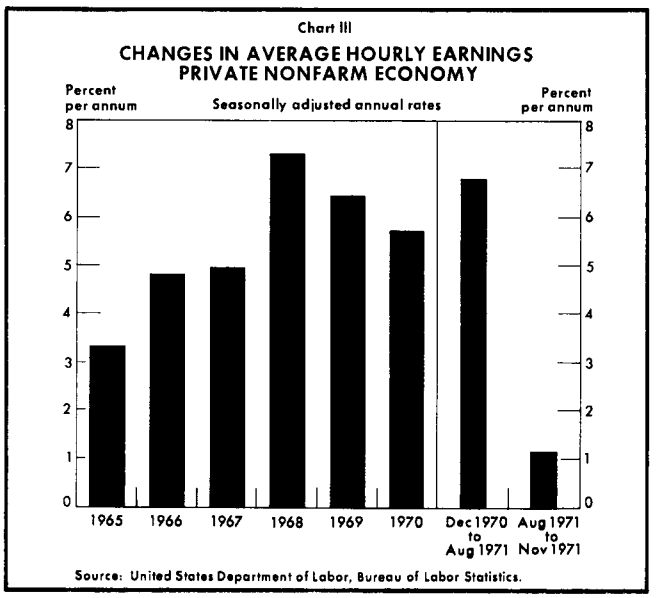
EMPLOYMENT, WAGES, AND PRICES

In December, labor market conditions showed little change as the unemployment rate inched up 0.1 percentage point to 6.1 percent. Thus, the unemployment rate at the end of 1971 was virtually unchanged from the reading registered at the close of 1970. To be sure, employment based on the household survey has shown some improvement in recent months. In the October-December period, for example, the average level of civilian employment exceeded the third-quarter average by 780,000 workers. However, since this gain was roughly matched by a large increase in the labor force, the unemployment rate was essentially unchanged. In contrast to the household survey, the nonagricultural payroll survey showed only modest employment gains in December and the fourth quarter. In the key manufacturing sector, in particular, employment showed little change as producers were apparently able to meet their additional labor requirements by a slight lengthening of the workweek.

Wage data for recent months indicate that the ninety-day freeze was quite effective in braking the speed at which wage rates had been climbing. Within the private nonfarm economy, the average hourly earnings of production and nonsupervisory workers rose at a seasonally adjusted annual rate of only 1.2 percent between August and November (see Chart III). This time span approximately corresponds with the freeze period, since the August survey was taken in the week before the freeze was announced while the November survey was taken in the week prior to the expiration of the freeze. Most, if not all, of this rise probably stemmed from increased overtime and job shifts within firms or between firms in the same industry and other compositional shifts among the employed work force. In comparison, over the first eight months of the year, these workers' average hourly earnings had been surging ahead at a 6.9 percent annual rate.

In coming months, wage developments will be heavily influenced by the guidelines and decisions of the newly established Pay Board. Soon after its appointment, the Pay Board announced that its broad objective would be to limit the increases in total employee compensation to an annual rate of 5.5 percent—though its initial decisions have permitted considerably larger rises. This guideline notwithstanding, it appears likely that average hourly earnings[1]

[1] Because the average hourly earnings figures exclude some fringe benefits and other wage supplements, such as health insurance and contributions to retirement, they are less comprehensive than total employee compensation.



will show relatively large increases in December and January as a result of a clustering of wage hikes—including some retroactive ones—that would otherwise have occurred during the months covered by the freeze. Many workers, for example, were scheduled to receive merit pay raises and deferred wage boosts between August 15 and November 13. Similarly, negotiations on some new collective bargaining agreements were discontinued during the freeze while the participants awaited the announcement of details on Phase Two. Most of the wage increases that were postponed during the freeze are likely to be implemented in the first couple of months after its expiration, along with the wage increases that were previously scheduled to become effective in these months. Depending on how soon after November 13 these raises occur, they will be reflected in the December or January survey results. Even if the guideline of 5.5 percent were to become a ceiling for all of the individual raises, the bunching of increases customarily spread over several months into two months could tend to inflate the size of the wage increase in those two months well beyond the 5.5 percent figure. Thus, the 10.8 percent annual rate of increase that occurred in December in the average hourly earnings of production and nonsupervisory workers in the private nonfarm economy was not unexpected.

The presently available statistics on consumer prices apply to the time period prior to Phase Two. On the basis of revised data, consumer prices climbed 1.7 percent on a seasonally adjusted annual rate basis between August and November, following a 3.8 percent annual rate of increase over the previous eight months of 1971. Including an allowance for the retroactive elimination of the automobile excise tax, which has been signed into law by the President, prices of nonfood consumer commodities are now reported as having been unchanged on a seasonally adjusted basis over the August-November period. While food prices edged up only slightly, most of the advance in the overall consumer price index from August to November was centered in services prices. These prices increased at a nonseasonally adjusted annual rate of 3.1 percent from August to November, significantly less than the rate of increase earlier in the year.

PERSPECTIVE '71

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The Business Situation

Recent business indicators confirm that some acceleration of the economic recovery occurred toward the end of 1971 following a lethargic showing over most of the year. In the fourth quarter, real gross national product (GNP) advanced at a 6 percent annual rate, about double the very sluggish rate of increase in the two preceding quarters. Similarly, the tempo of industrial production quickened somewhat toward the year-end. There are some signs that the recently increased economic momentum may be carrying into 1972. The record levels of housing starts and building permits in December increased the likelihood that the housing boom will continue into the opening months of the year, while the latest surveys of plant and equipment spending intentions for 1972 suggest that a strengthening of recently weak business investment could emerge this year. On the other hand, post-freeze developments in retail sales, together with the continued high rate of personal savings, provide no clear indication that consumers have overcome their hesitancy. However, the net tax reductions for most income groups that took effect in January should help to bolster consumer demand. As yet, the improved pace of the recovery has not had a significant influence on the unemployment rate, although the rate slipped slightly in January.

The recent data on wages and prices—while showing some encouraging developments—do not yet provide a firm foundation for evaluating the progress of Phase Two policies in combating inflation. To be sure, all of the major indexes of price and wage trends slowed markedly in the fourth quarter. Generally speaking, however, these data overstate the moderation in underlying inflation since they were heavily influenced by the mid-August to mid-November price and wage freeze. On the other hand, price data in the months immediately following the freeze may overstate inflationary trends as a result of the clustering of price and wage increases.

GROSS NATIONAL PRODUCT AND RELATED DEVELOPMENTS

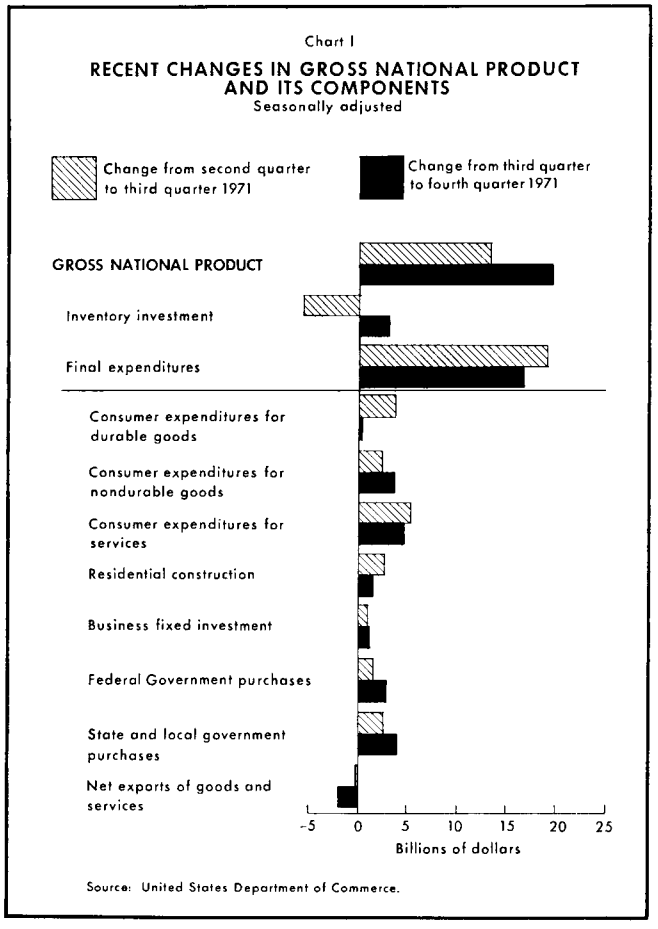
During the fourth quarter of 1971, the market value of the nation's output of goods and services rose by $19.6 billion (see Chart I) to a seasonally adjusted annual rate of $1,073.0 billion. The rise in real GNP—that is, GNP adjusted for price increases—was at a rapid 6.1 percent annual rate, the largest advance in more than three years except for the first quarter of 1971 which was swollen by the rebound from the General Motors strike. At the same time, the GNP price deflator rose at an annual rate of only 1.5 percent, the smallest since the beginning of the Vietnam escalation.

On the basis of newly revised data, real GNP growth during the second and third quarters of last year is now reported to have averaged a 3 percent annual rate, about 1 percentage point less than previously estimated. Normally, such revisions of the GNP data are not published until July of the following year. However, the need to adjust certain GNP components for retroactive provisions of the Revenue Act of 1971, together with some major revisions of the source data used to estimate GNP, prompted these earlier than usual revisions in the GNP accounts. One effect of these changes was to underscore even more forcefully the sluggishness of the economic recovery during most of 1971 and to make the fourth-quarter performance stand out in sharper contrast.

The fourth-quarter strengthening in the growth of GNP was partially a result of greater inventory spending. In the previous quarter, inventory spending as measured in the GNP accounts had actually declined, as users worked off excess steel inventories that had been accumulated earlier as a hedge against a possible strike. While the steel adjustment continued into the fourth quarter—as suggested by the virtually unchanged level of durables manufacturers' inventories on a book-value basis during November and December—the magnitude of the resulting drag on overall inventory spending was smaller than in the third quarter. More importantly, however, there was also some evidence of a strengthening in the underlying demand for inventories during the final months of the year. In part, this may have reflected the general improvement in confidence that appeared to characterize this period. Beyond this, the relatively low level of inventory-sales ratios in most sectors was conducive to higher demands

for stocks. These factors, especially if coupled with an acceleration of final sales, should lead to a still more expansionary rate of inventory spending in the months ahead which in turn would tend to stimulate production and employment.

The most recent readings of the Federal Reserve Board's index of industrial production provide some evidence of a quickening in the pace of industrial output. Indeed, increases in November and December industrial production averaged a fairly substantial 0.7 percent. While part of these gains resulted from the resumption of coal production following the coal miners' strike, the advances in output excluding coal were still fairly sizable. Moreover, these most recent gains in production were broadly based, as December production levels in virtually every major grouping were above their October readings. One major exception to this rule was the production of motor vehicles and parts which stood at 0.4 percent below its October level.



The failure of automobile production to show added strength at the year-end may have been a reflection of the sharp downturn in sales of domestically produced cars that occurred in December. Indeed, new car sales, which surged almost immediately after the President's August 15 speech and continued at a rapid rate into the fourth quarter, dropped off during late November and in December. This suggests that at least some of the spurt in purchases represented buyer attempts to avoid higher future car prices. Increases were, in fact, allowed by the Price Commission after the end of the freeze. Sales of imported automobiles have tended to weaken since cresting in mid-1971, but it is impossible to determine how much of this was the consequence of shortages resulting from longshoremen labor disputes as distinct from the higher import prices stemming from the temporary import surcharge and from the international currency realignments.

The end-of-quarter weakening in automobile sales was one factor that held the fourth-quarter rise in consumer spending to a modest $8.9 billion, a somewhat smaller gain than was registered in the two preceding quarters. Because of the dramatic impact of the freeze on the rate of inflation, however, the October-December quarter's gain in real consumption amounted to a 4 percent annual rate, the same as in the second and third quarters. In addition to the December slowdown in auto sales, nonautomotive retail sales closed the year on a somewhat weak note. On the other hand, consumer credit outstanding continued to grow quite rapidly in the final months of 1971. The increased willingness of consumers to finance purchases through credit may be an indication of an improvement in consumer confidence. In any event, the outlook for consumer spending has been enhanced by the net tax reductions for most income groups which took effect in January of this year.

Despite the moderate advance in current-dollar consumption spending in the fourth quarter, the ratio of personal savings to disposable or after-tax income fell by 0.4 percentage point to 7.7 percent. This decline in the savings rate was primarily a reflection of accelerated collections procedures for estate and gift taxes, which temporarily increased personal tax payments by about $3 billion in the fourth quarter and thereby depressed the level of disposable income. However, since this change in collections procedures was not likely to have had a major impact on consumer spending, it can be assumed to have been the principal cause of the reduced savings rate. And, even without allowance for this factor, the savings rate in the fourth quarter remained very high by historical standards.

Home-building activity continued to expand in the fourth quarter from the very high levels attained earlier

in the year. Indeed, the monthly record for the level of seasonally adjusted housing starts was shattered by November's 2.3 million unit annual rate and again by December's 2.5 million units. Although the small December seasonal factor may have exaggerated the effect of exceptionally good weather, during the fourth quarter as a whole housing starts increased at a 22 percent annual rate over the level attained in the previous three-month period. At the same time, newly issued building permits, which are an advance indicator of home-building starts, climbed at about a 27 percent annual rate. In short, despite the record performance of the housing sector during 1971, indications are that this upward momentum may carry into the opening months of 1972. The recent declines in most market interest rates should further strengthen the competitive position of the nation's thrift institutions, thereby facilitating the continued ample flow of credit into the residential mortgage market.

The growth in business fixed investment expenditures was a modest $1.1 billion in the final quarter of 1971, about the same as in the previous three months. During the fourth quarter, and for the year as a whole, low levels of industrial capacity utilization as well as the sluggish pace of the recovery had a depressing impact on business fixed investment, particularly in the manufacturing sector. However, recent indications suggest that a more expansionary spending pace may emerge in 1972. For example, between June and December 1971, the index of industrial production for business equipment increased at an annual rate of 7.4 percent, reversing a two-year downward trend. Similarly, the most recent survey of capital spending plans conducted jointly by the Department of Commerce and the Securities and Exchange Commission indicates that such investment is expected to rise by about 9.1 percent in 1972, a figure which is roughly in line with other recent survey results. Manufacturing companies are expected to increase investment spending by 4 percent, a marked contrast to the 5.4 percent decline registered in 1971.

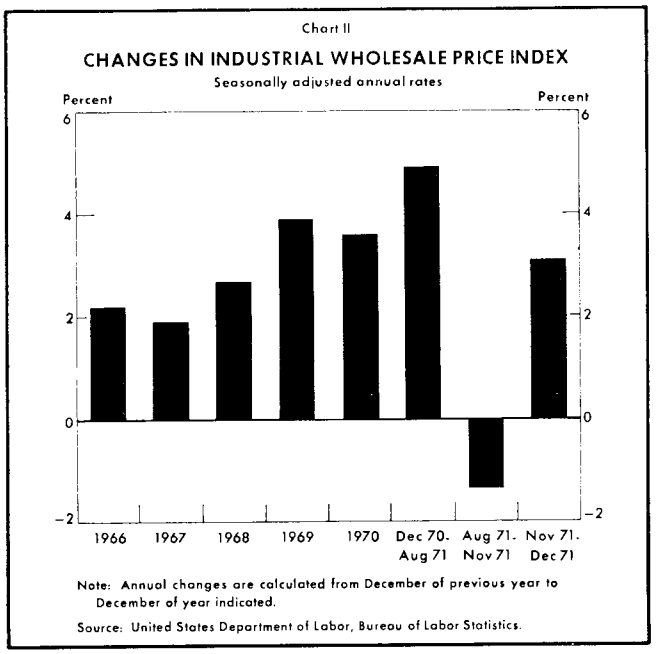
Government purchases of goods and services jumped by a very sizable $7 billion during the fourth quarter, or about three times the average quarterly gain in recent years. Increased spending by state and local governments accounted for $4 billion of this gain. Spending on structures, which had been particularly sluggish earlier in the year despite heavy state and local borrowing, rose sharply during the final quarter. At the Federal level, a military pay raise designed to help speed the transition to a volunteer army took effect in mid-November and accounted for about one third of the $3 billion rise in total Federal expenditures. A substantial increase in crop purchases under the price-support programs of the Commodity Credit Corporation was also a factor in the advance in Federal spending.

Net exports of goods and services posted a deficit of $2.0 billion in the fourth quarter, according to preliminary estimates. Since this account had been in balance during the preceding quarter, the fourth-quarter deficit represented a $2 billion drag on the overall advance of nominal GNP. The latest decline in net exports was primarily the result of the East and Gulf Coast dock strikes although, even apart from this factor, the trade position of the United States deteriorated sharply in 1971. In the future, however, the December 18, 1971 currency realignments and the ongoing trade negotiations should lead to an improvement in our position in the world markets, and thereby promote a strengthening in our net export position.

PRICES, WAGES, AND PRODUCTIVITY

Since August 15, a different framework has surrounded the making of price and wage decisions. Inflation rates slowed, in some cases quite dramatically, under the impact of the ninety-day wage and price freeze. While some rather sizable price and wage increases have taken place in the post-freeze period, a bunching of increases that might otherwise have been spread out over the three-month period of the freeze was to be expected. Under these circumstances, the advances recorded in the available price data for December and January have actually been smaller than might have been feared.

Some of the clearest manifestations of recent policy changes are to be found in the behavior of seasonally adjusted wholesale industrial prices (see Chart II). Over the first eight months of 1971, these prices soared at a 4.9 percent annual rate. They then declined at a 1.3 percent rate between August and November, and spurted at a 3.1 percent rate in December. Movements in consumer prices followed roughly similar contours, but the data collection procedures for consumer prices are such that not all prices for the items in the index are sampled every month. Thus, consumer price changes recorded during the freeze included some pre-New Economic Policy developments while changes recorded during the early stages of Phase Two are still a partial reflection of the freeze. The rise in consumer prices, which had proceeded at a 3.8 percent annual rate over the first eight months of last year, slowed to 1.7 percent during the freeze and then accelerated to a 4.6 percent annual rate of increase in December. The December rise in consumer prices was paced by a large increase in food prices, many of which had not been covered by the freeze. Nonfood commodity prices rose by a fairly substantial seasonally adjusted annual rate of 4.1 percent. However, because of the sampling procedures noted above,

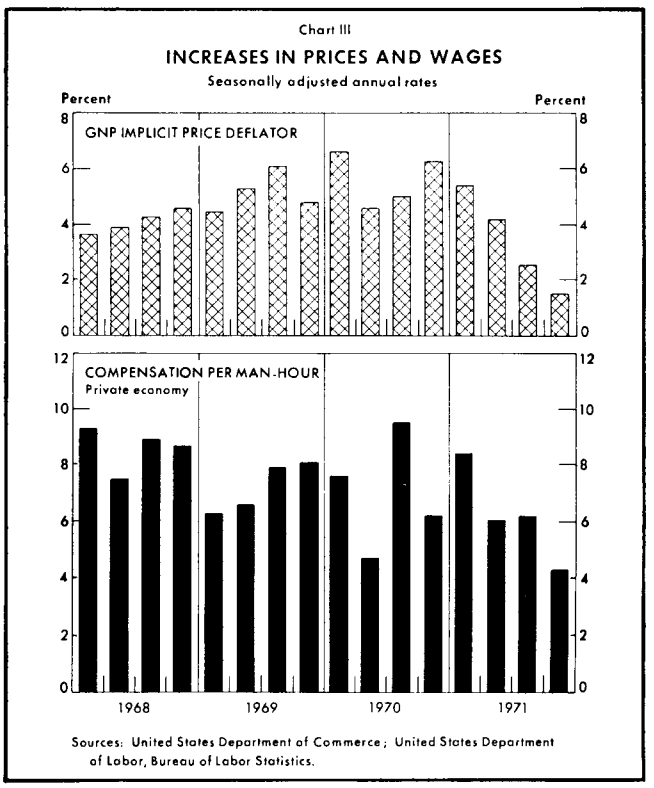


the December consumer price data probably did not fully capture the clustering of price increases that seems likely to have occurred following the termination of the freeze.

The implicit GNP deflator, which is the broadest available measure of price changes, rose at a relatively modest 1.5 percent annual rate during the fourth quarter (see Chart III). While this was the smallest such quarterly advance since 1965, the behavior of the deflator exaggerates the underlying moderation in inflation. For example, in the absence of the auto excise tax repeal, the deflator would have risen at an annual rate of about 2 percent. More importantly, because it is essentially an average of monthly price data during the quarter, most of the data used in estimating the deflator for the fourth quarter was collected while the freeze was still in effect. As a consequence, much of the post-freeze clustering of price increases will be reflected in the quarterly average level of the deflator for the first three months of 1972. Just as the deflator for the fourth quarter tends to understate the rate of inflation, its 1972 first-quarter showing will probably overstate the situation.

During the fourth quarter, the increase in compensation per man-hour in the private economy slowed to a 4.3 percent annual rate, a marked deceleration from the gains of 6 percent to 9 percent generally registered over the last several years. The fourth-quarter showing of compensation per man-hour was, however, also heavily influenced by the ninety-day freeze. Indeed, because compensation per man-hour is a measure of the quarterly average level of wage and benefit payments, most of the monthly data used to estimate it over the last three months of 1971 was collected while the freeze was still in effect. For example, between August and November, average hourly earnings—one of the monthly sources for the series on compensation per man-hour—rose at only a 2 percent annual rate. Reflecting the post-freeze clustering of wage increases, this series then shot up at an annual rate of 10 percent in December and a slower but still rapid 7 percent in January. This pattern of behavior suggests that the quarterly rise in compensation per man-hour—like most wage and price series—could accelerate at the start of 1972 as a large number of wage increases are concentrated into a relatively short time span.

Productivity, as measured by the index of output per man-hour in the private economy, rose at a 3.4 percent annual rate during the fourth quarter—slightly above its long-term trend. Excluding the farm sector, where productivity changes tend to be quite volatile on a quarterly basis, output per man-hour climbed at a 4.9 percent an-



nual rate in the final quarter, nearly twice as fast as in the preceding two quarters. As a consequence of the combined private economy compensation and productivity changes, labor costs per unit of output rose at a very small 0.7 percent annual rate, the slowest quarterly growth since 1965. However, because as noted earlier the rise in compensation was held down by the wage freeze, the increase in unit labor costs was similarly affected. Thus, these data do not provide a clear indication of the extent to which labor cost pressures on the price level have moderated.

Some very tentative signs of improved labor market conditions emerged from the surveys conducted by the Bureau of Labor Statistics during January. After strengthening in the closing months of last year, seasonally adjusted nonfarm payrolls rose by an additional 240,000 workers, the largest monthly gain since payroll employment bottomed out in November 1970. However, about one third of the overall January rise was concentrated in contract construction, possibly as a result of the exceptionally mild weather prevailing in some parts of the country during the month. The increase of 45,000 workers on manufacturing payrolls was accompanied by sizable declines in the average factory workweek and hours of overtime. According to the monthly household survey, the unemployment rate for January was a seasonally adjusted 5.9 percent. Although some of the data point to a firming of labor markets for experienced workers, the overall unemployment rate was probably not significantly changed from December's downward revised 6.0 percent.

Monetary and Bank Credit Developments in the Fourth Quarter

During the fourth quarter of 1971, the narrow money supply rose only slightly but the broader monetary and credit aggregates posted relatively large advances. The growth of M_1—adjusted demand deposits and currency held by the public—slowed to a seasonally adjusted annual rate of 1.1 percent in the fourth quarter from 3.7 percent in the third quarter of 1971 (see Chart I). While demand deposits were virtually unchanged in the fourth quarter, the expansion of time deposits accelerated. Consequently, the growth of M_2—which includes M_1 plus commercial bank savings and time deposits other than large-denomination certificates of deposit (CDs)—rose to 8.0 percent at an annual rate during the fourth quarter from 4.4 percent in the previous three-month period. The surge in time deposits was also reflected in the adjusted bank credit proxy. This aggregate consists of total member bank deposits subject to reserve requirements and such nondeposit sources of bank funds as Euro-dollar borrowings and commercial paper sold by bank holding companies and affiliates. The adjusted proxy increased in the fourth quarter of 1971 at a seasonally adjusted annual rate of 9.7 percent, up from the 7.6 percent rate of advance in the third quarter.

Bank credit—total commercial bank loans and investments adjusted for loan transactions with affiliates—increased in the final quarter of 1971 at a seasonally adjusted annual rate of 8.8 percent, virtually the same as the growth registered in the previous quarter. The overall strength in bank credit was paced by a large increase in holdings of tax-exempt securities. However, commercial and industrial loans outstanding remained practically unchanged during the fourth quarter, reflecting the sluggishness in business demands for short-term credit.

MONETARY AND RESERVE AGGREGATES

The narrow money supply (M_1) began moving higher in December after four months of virtually no growth. The December increase amounted to a modest 2.6 percent at a seasonally adjusted annual rate. This figure, however,

The Business Situation

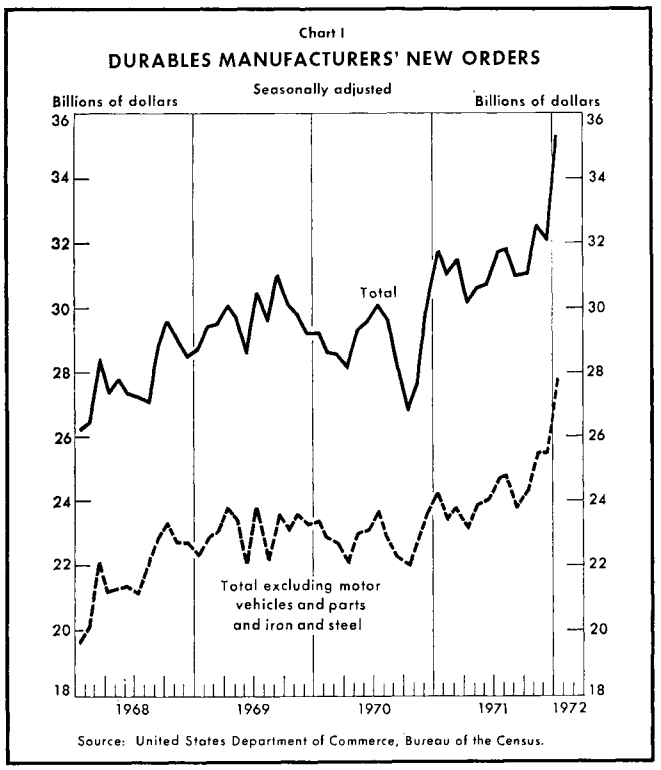
The economic data that have become available during the past few weeks suggest a continuation of the recent modest improvement in the uneven recovery from the 1969-70 recession.[1] Industrial production rose only slightly in January, but new orders for durable goods advanced strongly. Although part of 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.

[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.

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.



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.

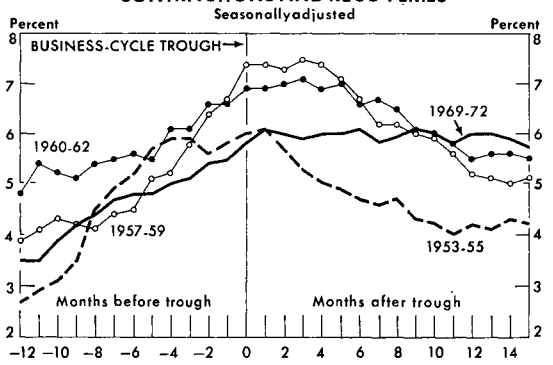
LABOR MARKET DEVELOPMENTS

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 in-

Fifty-seventh Annual Report

The Federal Reserve Bank of New York has published its fifty-seventh *Annual Report,* reviewing the major economic and financial developments of 1971.

The *Report* states that "the principal objective of monetary policy in 1971 was to achieve growth in the monetary and credit aggregates which would both support the economic recovery and be consistent with an orderly reduction in the rate of inflation. In addition, considerable attention was given to accommodating declines in, or alleviating upward pressure on, long-term interest rates to encourage the economic expansion that was getting under way." However, "the unsatisfactory performance of the domestic economy and the rapidly deteriorating position of the dollar" over the first eight months of the year provided the impetus for the new economic policies announced by President Nixon on August 15. Also, the December 18 agreement on a broad realignment of exchange rates among the Group of Ten countries helped, the *Report* noted, "restore a badly needed measure of international monetary order, but the more fundamental changes required to rebuild confidence in the viability of the international monetary system remained to be completed".

In his letter presenting the *Report,* Alfred Hayes, President of the Bank, observed that "the challenge of 1972 is to build upon the efforts to restore economic strength and stability that were begun in 1971". He further noted that "although the 'Phase Two' incomes policy meets an urgent need today, there is reason to hope that wage and price controls may eventually be abolished. To that end, we must guard against overly expansive fiscal or monetary policies, which might prolong our reliance upon direct controls while, at the same time, undermining their ultimate success." Mr. Hayes expressed the conviction that "the basic goal of economic policies must continue to be the achievement of satisfactory use of resources while restoring price stability and balance-of-payments equilibrium".

The *Annual Report* may be requested from the Public Information Department, Federal Reserve Bank of New York, 33 Liberty Street, New York, N.Y. 10045. A copy is being mailed to *Monthly Review* subscribers.

dependently 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.

The Business Situation

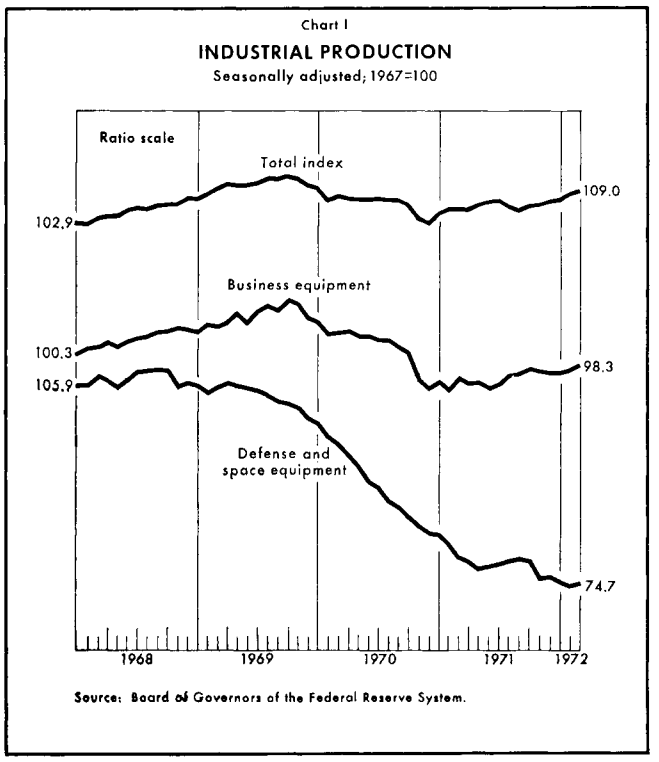
Recent data continue to point to a strengthening of the economic recovery. During February, industrial production exhibited a strong and broadly based advance and private housing units were started at a record rate. Consumers shed some of their lethargy and stepped up their purchases in February and 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.

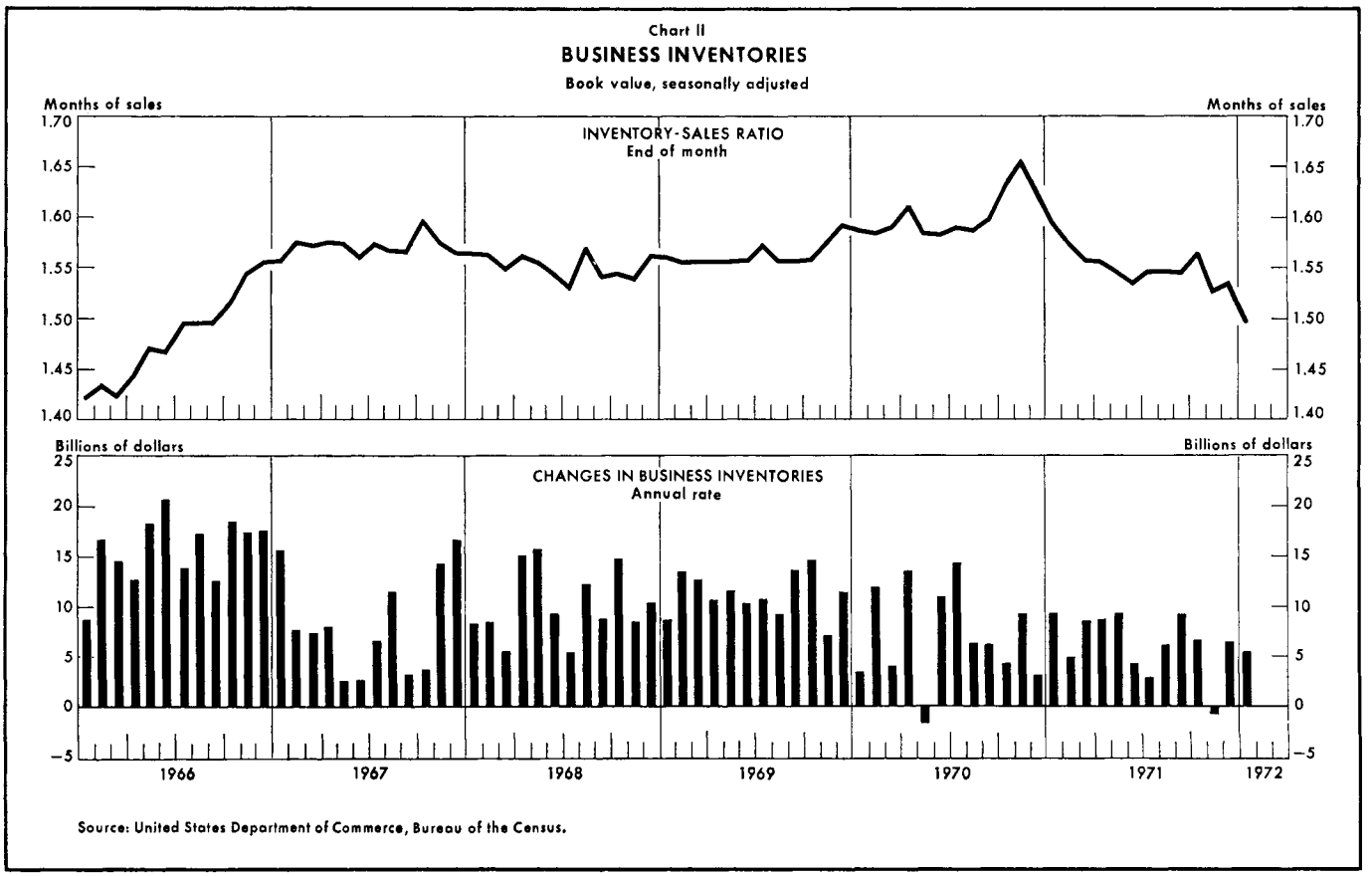
Developments in prices and wages suggest that inflation remains a serious problem. Large increases in food prices gave a sharp boost to both the consumer and wholesale price indexes in February. While wholesale agricultural prices declined slightly in March, prices of industrial commodities continued 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





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

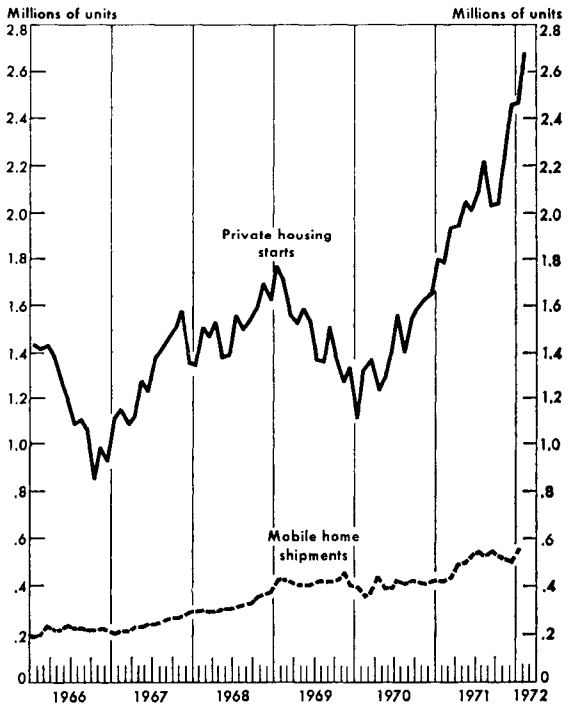
The housing boom has continued to show exceptional vigor. During February, the total number of private housing units started soared to a record 2.7 million unit seasonally adjusted annual rate, according to preliminary data (see Chart III). By comparison, housing starts had fallen to a low of 1.1 million 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.

The Business Situation

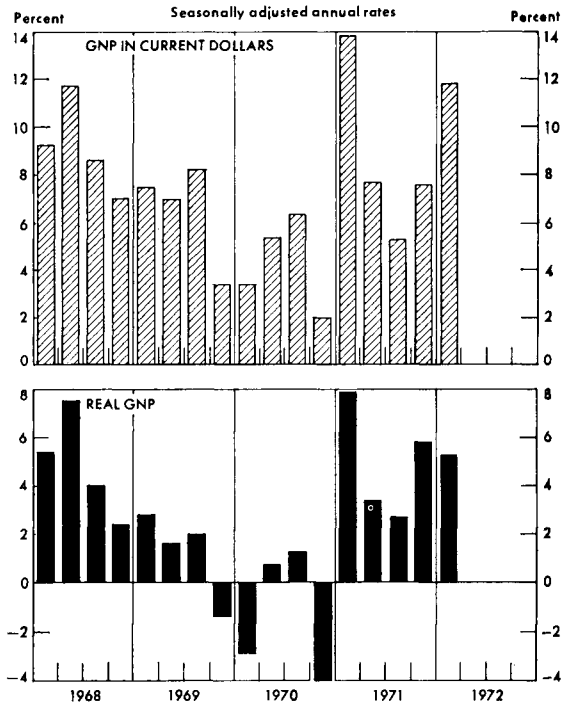
The most recent business statistics provide further evidence of a broadly based quickening in the pace of economic activity. Industrial production posted a pervasive and strong increase in March, and payroll employment continued to show upward momentum in April. Real gross national product (GNP) advanced 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

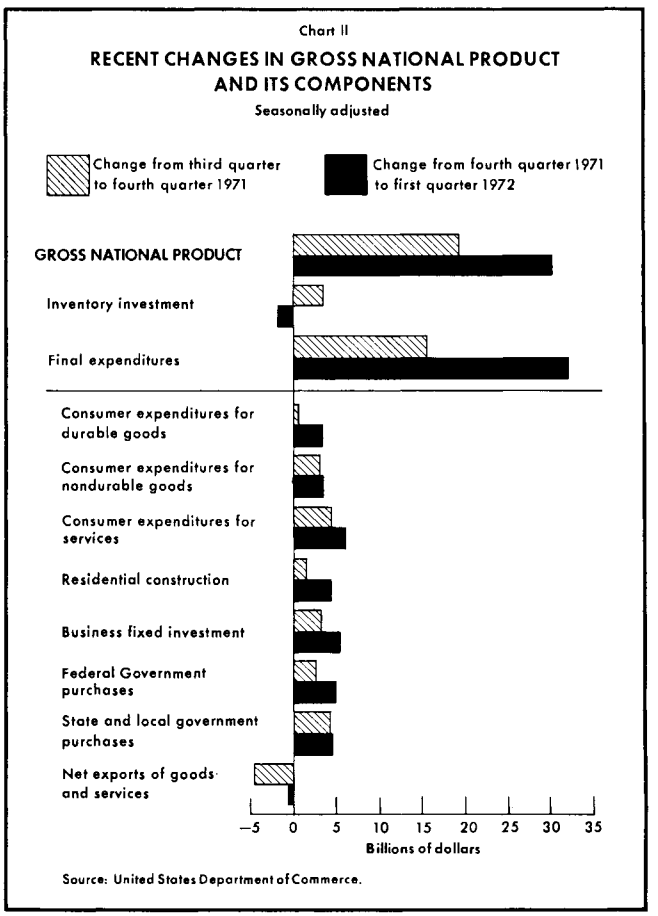


Source: United States Department of Commerce.

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).



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.

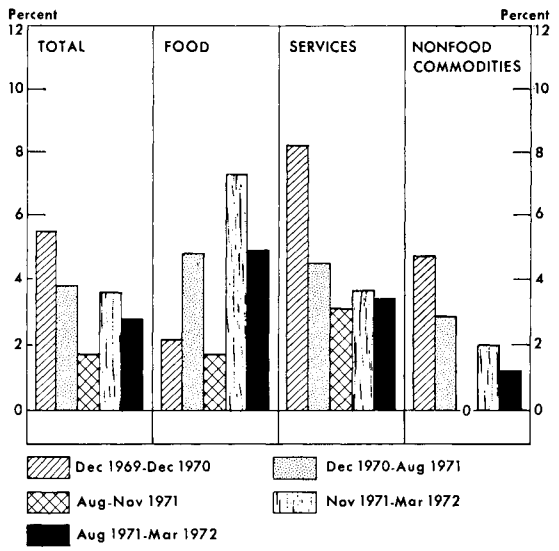
Government purchases of goods and services contributed $9.6 billion to the first-quarter GNP advance. Federal spending increased by $5.0 billion, a little more than half of which reflected Federal civilian and military pay increases. Even apart from the pay increases, however, defense spending quickened 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.

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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.

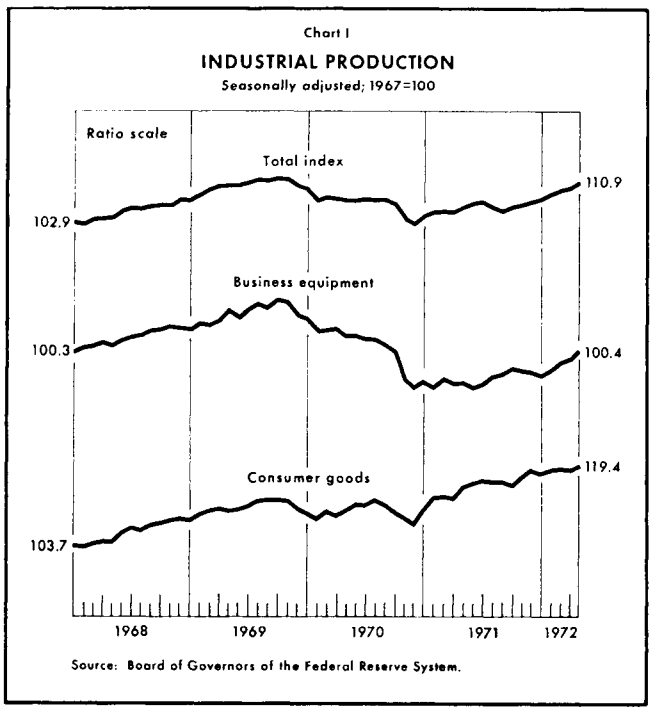
Price and wage data still provide no firm basis on which to judge the success of the Phase Two programs to combat inflation. Consumer prices rose at a modest seasonally adjusted annual rate of 2 percent in April after showing little change in the previous month. Thus far in Phase Two, consumer prices 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 1). 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-



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.

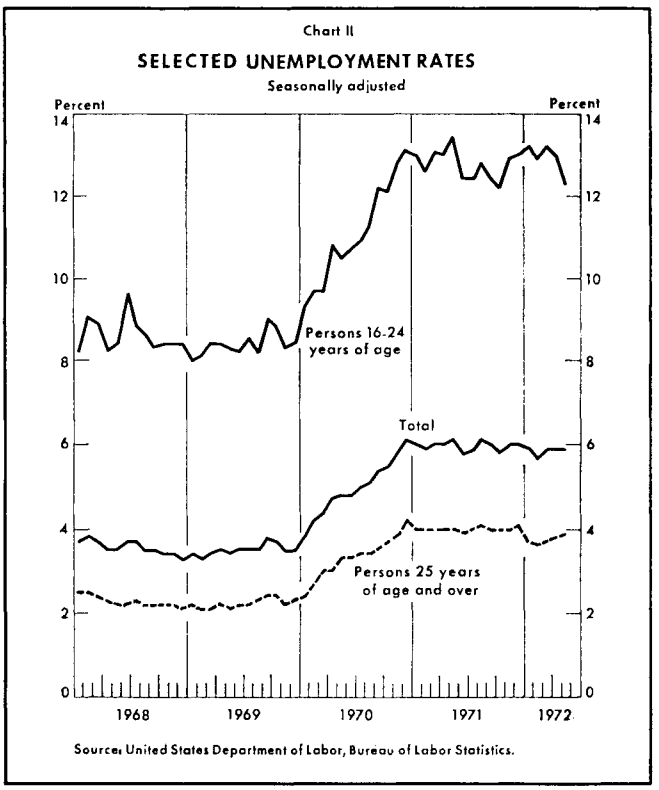
Although April retail sales dropped below the record March level, the overall picture still looks strong. Estimates for both February and March have been revised up rather substantially. Furthermore, the average level of sales for the March-April period was about $1 billion, or nearly 3 percent, above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

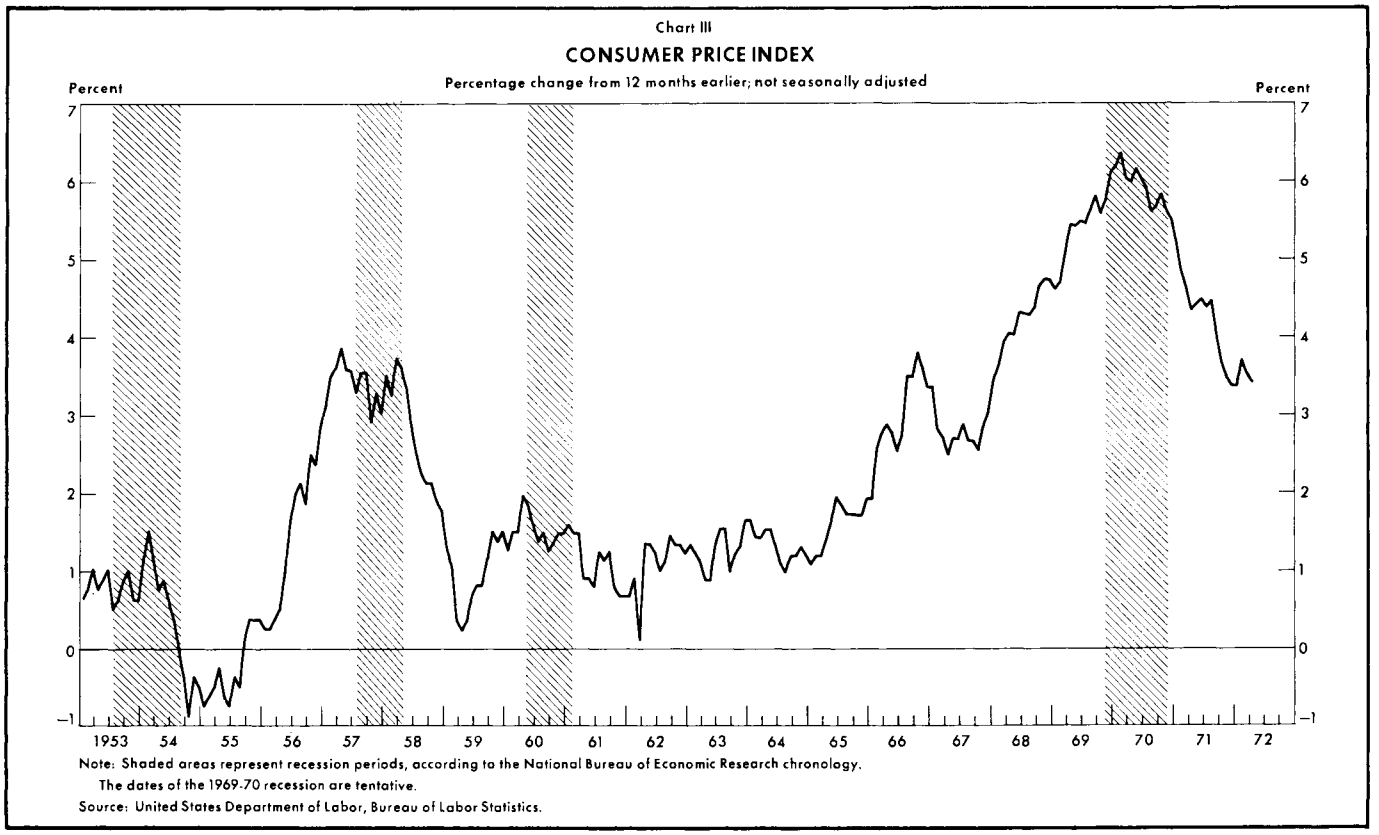
Thus far in 1972, there has been a marked improvement in underlying labor market conditions. According to the Bureau of Labor Statistics survey of employers, nonfarm payroll employment rose by a seasonally adjusted 206,000 workers in May, bringing the gain in nonfarm payrolls since the beginning of the 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.



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



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.

The Business Situation

Recent data indicate that economic activity has continued to expand briskly. Retail sales rose markedly in May but then dropped in June, according to preliminary information. Sales were probably held down in June by the storm which affected much of the East. Industrial production posted a moderate, though broadly based increase in May. Over the first five months of the year, output has risen at a rapid 9 percent annual rate. In May, personal income climbed at roughly the pace of the first four months of the year and the volume of residential housing starts increased after easing off in the two previous months. Moreover, there are tentative signs of some strengthening in inventory spending. The unemployment rate fell to a seasonally adjusted 5.5 percent in June, as employment increased and the civilian labor force declined by nearly 100,000 workers.

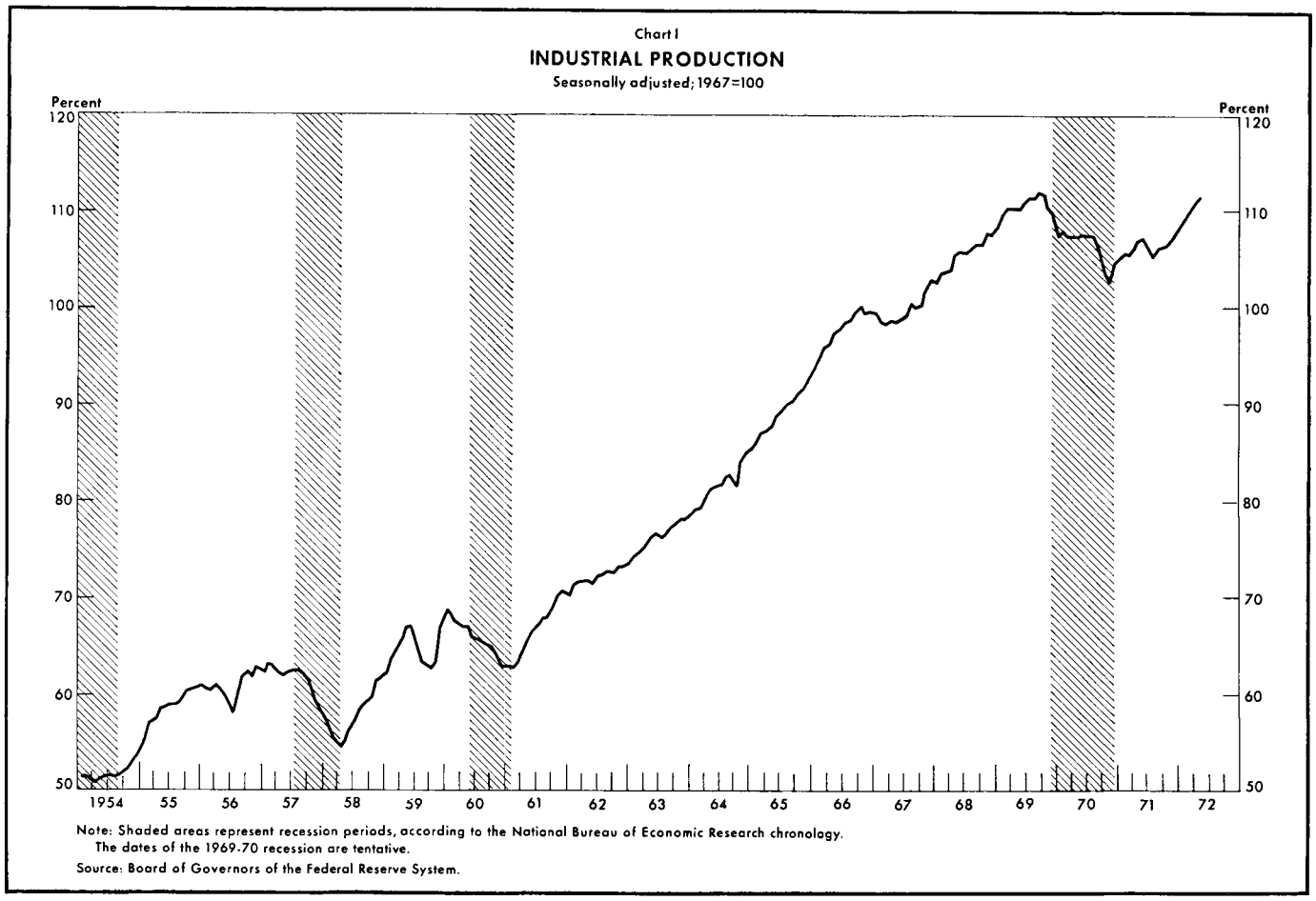
The latest price information suggests that inflationary pressures persist. Seasonally adjusted consumer prices, boosted by a rapid rise in prices of some nonfood commodities, increased at an annual rate of 4 percent in May. Retail food prices declined for the second consecutive month, but this improvement is not expected to be maintained. Wholesale prices of farm products and processed foods and feeds rose rapidly again in June, and industrial wholesale prices advanced at a disappointing 5 percent annual rate. June data reveal only a modest increase in wages for the second consecutive month, although over the Phase Two period as a whole wages have climbed considerably.

PRODUCTION, ORDERS, AND INVENTORIES

The Federal Reserve Board's index of industrial production rose in May by 0.5 percent on a seasonally adjusted basis, and the readings for the preceding three months were revised upward slightly. Thus, in recent months output has resumed rapid growth after the decline and subsequent stagnation associated with the recession of 1969-70 (see Chart I). Since the beginning of the year, industrial production has climbed at a fast 9 percent seasonally adjusted annual rate, roughly the pace of expansion registered between early 1961 and mid-1969, to reach a level only 0.3 percent below its peak of September 1969. The May increase in output was widespread, including gains in the production of consumer goods, business equipment, and intermediate products. On the other hand, output of defense and space equipment and of materials edged down a bit following sharp advances in April.

The May rise in production of consumer goods was 10 percent at an annual rate. Output of most appliances, furniture, and consumer nondurable goods increased, while automobile assemblies declined somewhat from their April pace despite the strength of automobile sales. Since December 1971, consumer goods output, seasonally adjusted, has advanced at an annual rate of 6.7 percent, with the increase concentrated largely in durable goods. Output of business equipment climbed at an annual rate of 8.3 percent in May, after an upward revised increase of nearly 17 percent in April. Over the first five months of 1972, production of business equipment has risen rapidly at an annual rate of 12 percent and, in May, stood at 7.5 percent above its level of a year earlier.

Orders placed with manufacturers of durable goods edged up by about $0.1 billion in May. Excluding the volatile transportation equipment sector, bookings rose by a healthy $0.7 billion, or 2.8 percent, to a seasonally adjusted $26.6 billion (see Chart II). This series, along with manufacturers' shipments, unfilled orders, and inventories, has recently been revised to reflect new bench marks derived from the annual *Survey of Manufacturers* and new seasonal adjustment factors. As a result, there have been substantial downward revisions in the orders and shipments series, while inventory levels, and therefore inventory-sales ratios, were revised upward. In any event, in May new orders for electrical machinery and primary metals rose, while bookings for transportation equipment fell more than $0.6 billion after posting a gain of similar magnitude in the previous month. Bookings for nondefense capital goods, a new category which replaces producers' capital equipment, were off slightly in May but



were still about 21 percent above the level of May 1971. Shipments of durable goods climbed modestly to a new record, while the backlog of unfilled orders increased for the eighth consecutive month.

There are tentative indications of some pickup in inventory spending after a prolonged period of sluggishness. During April, the book value of total business inventories increased at an $8.3 billion annual rate following an upward revised March gain of $6.2 billion. Trade stocks rose substantially, particularly at the wholesale level, but manufacturers' holdings declined slightly. However, preliminary May manufacturing data suggest a strengthening in inventory spending in this sector, as seasonally adjusted holdings climbed $4.9 billion at an annual rate. This gain occurred entirely in the durable goods sector. In 1972 thus far, manufacturers' inventories have risen at a $2.8 billion annual rate after remaining virtually flat throughout 1971. For all manufacturers, the ratio of inventories to sales was 1.69 in May, the same as April's upward revised level.

RETAIL SALES, PERSONAL INCOME, AND RESIDENTIAL CONSTRUCTION

Recent data provide impressive evidence of continued strengthening in consumer spending. In May, seasonally adjusted retail sales climbed $0.6 billion above the upward revised April level to a record $36.9 billion. Sales of both durables and nondurables increased, with automotive sales accounting for much of the strength in durables. Among nondurables, sales of general merchandise and food rose sizably. Preliminary June data indicate a drop in retail sales from the May peak, but spending was still a healthy $36.4 billion. Moreover, June sales were

undoubtedly held down somewhat by the tropical storm which affected much of the East Coast. Nevertheless, over the second quarter retail sales were a substantial 2.8 percent above the first-quarter average. In June, sales of new domestic-type automobiles moderated somewhat from their very rapid May pace to a 9 million unit seasonally adjusted annual rate, still a strong showing. Over the April-June period, sales of new domestic-type autos averaged 9.2 million units at an annual rate by comparison with an 8.7 million unit pace in the first quarter. Meantime, sales of imported cars were at an annual rate of 1.6 million units in June by comparison with 1.5 million units in both April and May.

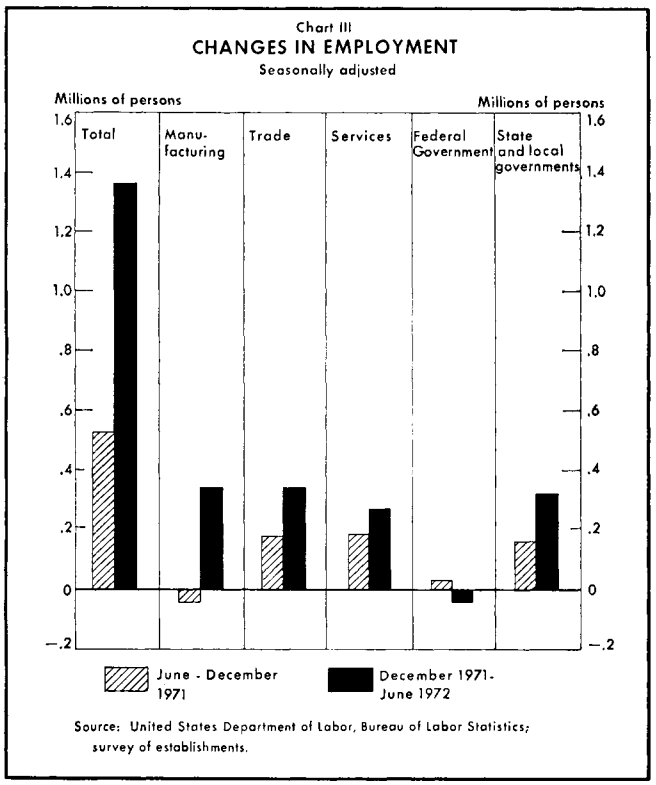
Personal income posted a $4.8 billion increase in May, reaching a seasonally adjusted annual rate of $915.9 billion. It should be noted that month-to-month fluctuations in this series have been affected recently by retroactive payments of wage increases approved by the Pay Board, as well as by other special factors. After adjustment for these influences, the May gain in personal income was $5.3 billion, roughly in line with the adjusted increases of the past several months. Further, over the January-May period, personal income averaged $905.4 billion, 8 percent above the average of the first five months of 1971. Wage and salary disbursements were up moderately in May, with a rise in manufacturing payrolls providing about half of the overall gain. The durable goods sector, particularly primary and fabricated metals and machinery, accounted for most of the rise in manufacturing payrolls.

After declining for two consecutive months, the pace of private housing starts increased by 221,000 units in May to a volume of 2.3 million units at a seasonally adjusted annual rate. While this was below the extraordinarily strong performance of the first quarter, it nevertheless represented a healthy total by most other standards. The May advance was concentrated in starts of single-family units, which climbed to their highest level in four months. Newly issued building permits increased slightly in May as well. Recent information suggests a modest tightening in mortgage market conditions. The average interest cost on conventional new home mortgages inched higher in May as did the effective rate on loans for existing homes. Moreover, the secondary-market yields of Federal Housing Administration-insured loans edged up for the second consecutive month.

LABOR MARKET DEVELOPMENTS

According to the monthly survey of households, civilian employment, seasonally adjusted, rose by 273,000 workers in June, while the labor force decreased by 91,000. As a consequence, the unemployment rate fell to 5.5 percent after holding steady at 5.9 percent over the previous three months. In June, the rates of unemployment for most major labor force groups declined, with a particularly pronounced drop in joblessness among teen-agers. This decline stemmed, in part, from a smaller than seasonal influx of young people into the labor force. At the same time, the unemployment rate for adult men dipped to 4 percent, compared with 4.3 percent in both April and May, and the rate of unemployment for adult women fell to 5.5 percent in June from 5.9 percent in May. On balance, these data suggest that the rather substantial increases in employment in recent months have begun to have an impact on joblessness. Over the April-June period, civilian employment averaged a sizable 589,000 above the level of the first quarter, an annual rate of increase of 2.9 percent. Expansion of the labor force was also rapid in the second quarter, amounting to 2.5 percent at an annual rate.

After several months of sizable gains, the most recent survey of establishments indicates only a small increase in nonfarm payroll employment in June. With this advance,



nonfarm employment reached a level 2.7 percent above that of a year earlier. Growth has been more rapid since the end of 1971, proceeding at a 3.9 percent seasonally adjusted annual rate over the first half of this year. Manufacturing employment declined in June, but over the January-June period manufacturing payrolls have risen by a healthy 342,000 workers, or 3.7 percent at an annual rate. In contrast, during the last half of 1971, factory employment dropped by more than 40,000 workers (see Chart III). About 75 percent of the gain in manufacturing jobs over the last six months has occurred in durable goods industries. The rise has been widespread within the durables sector, as there have been sizable employment increases in primary and fabricated metals, machinery, electrical equipment, and transportation equipment. The average factory workweek and hours of overtime both were essentially unchanged in June.

Most other areas of the economy have experienced gains in employment in recent months, which surpassed the increases in the last half of 1971. For example, over the first six months of this year, employment in trade and services rose by 336,000 and 270,000 workers, respectively, whereas the corresponding advances between June and December 1971 were less than 200,000 workers in each case. Total government employment, including Federal, state, and local but excluding the armed forces, rose slightly in June to a level 3.7 percent above that of a year earlier. Thus far in 1972, government employment has increased at an annual rate of 4.3 percent. All of this increase has been at the state and local government levels, as such employment rose by 317,000 workers over the six months ended in June. In contrast, reductions were ordered in Federal employment as part of the package of new economic policies instituted in August 1971 and, over the past ten months, Federal civilian employment declined in addition to the sizable reduction in the armed forces.

This pattern of growth in government employment has prevailed for some time. Between June 1969 and June 1971, Federal civilian employment dropped by about 140,000 workers while employment at the state and local levels climbed by nearly 760,000. As a result, state and local governments have accounted for an increasing portion of overall government employment. In June 1972, state and local employment constituted more than 80 percent of civilian government employment, whereas in June 1969 it made up about 77 percent of the total. The recent declines in Federal civilian employment have centered on the Department of Defense, as jobs in most other areas have held relatively steady.

Seasonally adjusted 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, increased at a 1.8 percent annual rate in June. This marked the second consecutive month of modest growth in earnings. Over the seven months since the end of the wage freeze last November, the index has climbed at a considerably more rapid 7 percent rate, about the pace of 1970 and the first eight months of 1971. However, excluding the sharp advances of December and January which may have resulted from a post-freeze bunching of increases, earnings have advanced at an annual rate of only about 4.5 percent over the five months ended in June.

RECENT PRICE DEVELOPMENTS

The latest price statistics suggest that serious inflationary pressures still persist. The consumer price index rose at a 4 percent seasonally adjusted annual rate in May, despite the second consecutive monthly decline in retail food prices. Moreover, food prices advanced sharply at the wholesale level in May and June, and it is likely that consumer food prices will soon reflect these increases.

Reportedly, retail prices of meats and some other products increased considerably in the last half of June. Because of the timing of the survey, these rises probably will not affect the consumer price index until July. To help slow the advance of food prices, the President recently removed quota restrictions on imported meats and, shortly thereafter, controls were extended to cover prices of some unprocessed foods at the wholesale and retail levels. In any event, over the past three months, consumer prices have advanced moderately at an annual rate of 2.1 percent, while over the Phase Two period as a whole they have moved up at a 3.5 percent rate, modestly below the pace of the first eight months of 1971. Food prices have climbed at a 4.4 percent pace over the six months ended in May, somewhat slower than the 5 percent annual rate of gain registered in 1971 before the price freeze.

The May rise in the consumer price index stemmed from a rapid advance in prices of some nonfood commodities; in contrast, service charges increased moderately. Nonfood commodity prices rose at a 6.2 percent seasonally adjusted annual rate in May, the fastest pace in a year. Prices for used cars and gasoline climbed particularly sharply. With the large May increase, the index for all commodities less food has now risen at an almost 3 percent annual rate since the termination of the price freeze, the same pace as during the first eight months of 1971. Nevertheless, this still represents considerable improvement relative to the increases experienced in nonfood commodity prices in 1970 and 1969.

At the wholesale level the advance of prices has continued to be disappointingly rapid. In June, such prices, seasonally adjusted, climbed at a 5.7 percent annual rate. With this increase, wholesale prices have risen at a 5.2 percent rate following the termination of the price freeze, the same pace experienced over the first eight months of 1971. Wholesale prices of farm products and processed foods and feeds increased at nearly a 6 percent annual rate in June while, at the same time, industrial wholesale prices advanced at a 5 percent rate. Prices of hides, skins, leather, and related products and prices of lumber and wood products rose very sharply again in June. In Phase Two thus far, industrial wholesale prices have increased at a 4.3 percent annual rate by comparison with the 4.7 percent pace of the first eight months of 1971.

The Business Situation

The economy continues to exhibit an impressive and broadly based expansion. Real gross national product (GNP) rose at a vigorous 8.9 percent seasonally adjusted annual rate in the second quarter, as almost all major components contributed to the advance. Moreover, this gain followed sizable upward revised increases in real GNP in the two preceding quarters. Industrial production posted only a moderate increase in June, but over the first half of the year output rose at a rapid 8.5 percent annual rate. Both civilian employment and labor force changed little in July, on a seasonally adjusted basis. Consequently, the unemployment rate remained at 5.5 percent for the second consecutive month, down markedly from its average level of 5.9 percent that had prevailed since late 1970.

Recent data on wages and prices show some definitely encouraging developments. The pace of wage increases has slowed somewhat, and unit labor costs declined in the second quarter for the first time in over six years. The implicit GNP price deflator—the most comprehensive available measure of price behavior—rose at a relatively modest 2.1 percent annual rate in the second quarter, but shifts in the composition of output caused some understatement of actual inflation. The rise in consumer prices has been appreciably slower in the last four months. On the other hand, throughout the period since the end of the price freeze last November the wholesale price index has continued to rise rapidly.

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 $29.9 billion during the second quarter to a seasonally adjusted annual rate of $1,139 billion. Measured in current dollars, the increase was a bit smaller than the advance in the first quarter. However, only about one fifth of the most recent gain was accounted for by price increases, whereas in the first quarter price rises constituted almost half of the expansion in nominal GNP. Hence, the growth in real GNP—that is, GNP adjusted for price changes—accelerated sharply in the April-June period to a seasonally adjusted annual rate of 8.9 percent, the largest quarterly percentage increase in real GNP since the fourth quarter of 1965. Along with the preliminary data for the second quarter, the Department of Commerce released its annual revisions of the GNP data going back through 1969. Estimates of real GNP were revised upward significantly for the final quarter of 1971 and the first quarter of this year. Over these two quarters combined, real GNP growth is now estimated to have averaged 6.6 percent per annum, nearly 1 percentage point more than was previously reported. These latest figures bring the increase in real GNP over the four quarters ended in the second quarter of 1972 to a healthy 6.1 percent, significantly above the gain for any comparable period in the past six years (see Chart I).

Inventory investment as well as final spending apparently rose substantially in the second quarter. Tentative and incomplete data indicate that the annual rate of inventory accumulation in the GNP accounts accelerated to $4.3 billion in the April-June period as compared with only $0.4 billion in the preceding quarter. Thus, after a prolonged period of sluggishness, inventory spending provided a $3.9 billion stimulus to the overall advance of GNP (see Chart II). Prospects appear to be good for further gains in inventory investment in the months ahead in line with increases in sales. Business inventory-sales ratios, particularly in the manufacturing and retail sectors, remain at relatively low levels. Moreover, the latest survey conducted by the Department of Commerce found that manufacturers expect to add substantially to their inventories in the third quarter.

The second-quarter rise in current-dollar final expenditures—i.e., GNP net of inventory accumulation—amounted to $26.1 billion, down from $32.2 billion in the first quarter. In real terms, however, final spending rose at a rapid 7.2 percent annual rate, a shade higher than the growth over the January-March period. Among the components of final expenditures, consumer spending

and business fixed investment were particularly strong, while residential construction rose modestly. Net exports of goods and services was the only major component which failed to contribute to the overall expansion of GNP, as the gap between imports and exports of goods and services widened slightly to an annual rate of $4.9 billion.

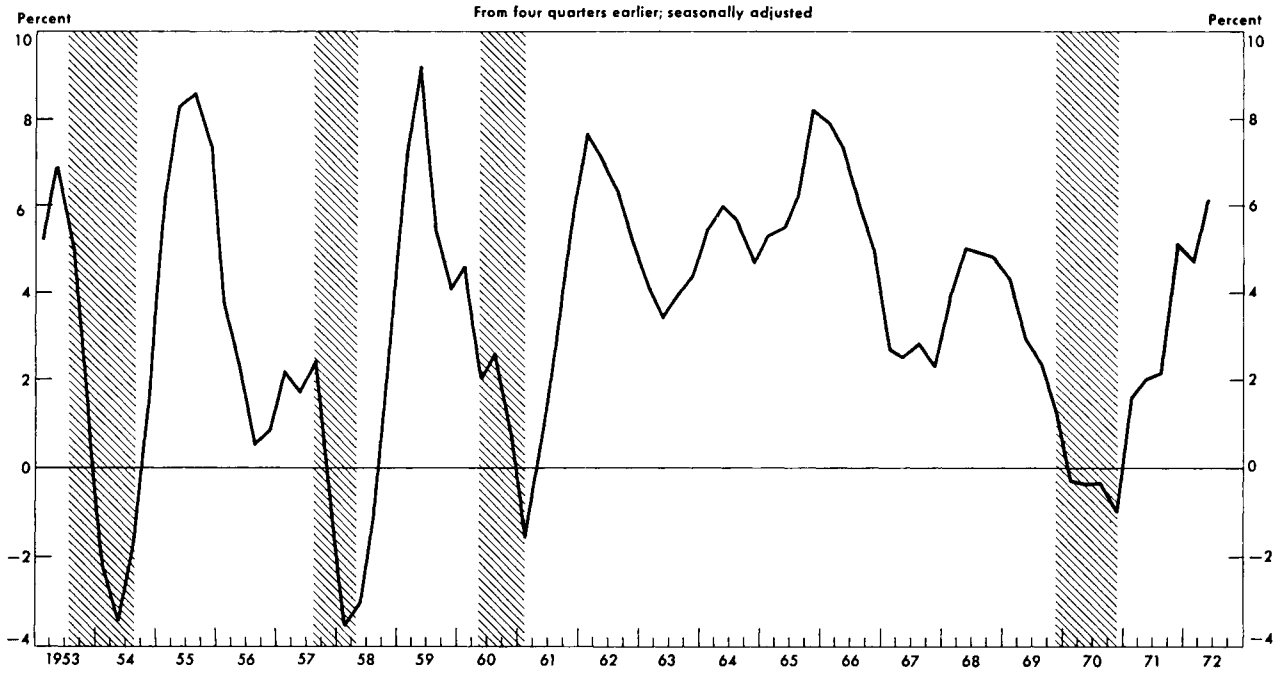
Personal consumption expenditures rose by $16.4 billion over the April-June period to a seasonally adjusted annual rate of $712.5 billion. Outlays for nondurable goods and services posted relatively strong gains, while the increase in spending for durables moderated somewhat from the pace of the previous quarter. The large second-quarter rise in overall consumer spending as recorded in the GNP accounts had been presaged by developments in retail sales during the quarter. Such sales were particularly strong in May, but according to preliminary June data—which could be revised substantially—retail sales declined by $500 million in that month after increasing by an average of $400 million per month over the January-May period. Automotive sales as well as sales of other durables and nondurables were all down substantially in June. However, retail sales may have been held back significantly in that month by the effects of flooding in the northeastern part of the country. In any event, recent surveys of consumer attitudes indicate that the consumer remains in a relatively strong buying mood. In addition, the recently enacted social security measures which provide a 20 percent general benefit increase with payments beginning in October should provide a boost in consumer spending in the fourth quarter.

The severe flooding in the East seems also to have had a significant effect on personal income in the final month of the quarter. After registering sizable gains in April and May, personal income was essentially flat in June when sharp declines in proprietors' income and rental income offset the rise in wage and salary disbursements. Over the quarter as a whole, personal income rose by $15.5 billion, a considerably smaller increase than the $25.5 billion advance of the first quarter. It should be noted, though, that the first-quarter rise was boosted by several nonrecurring special factors. Disposable after-tax income grew by $12.4 billion over the April-June period, about the

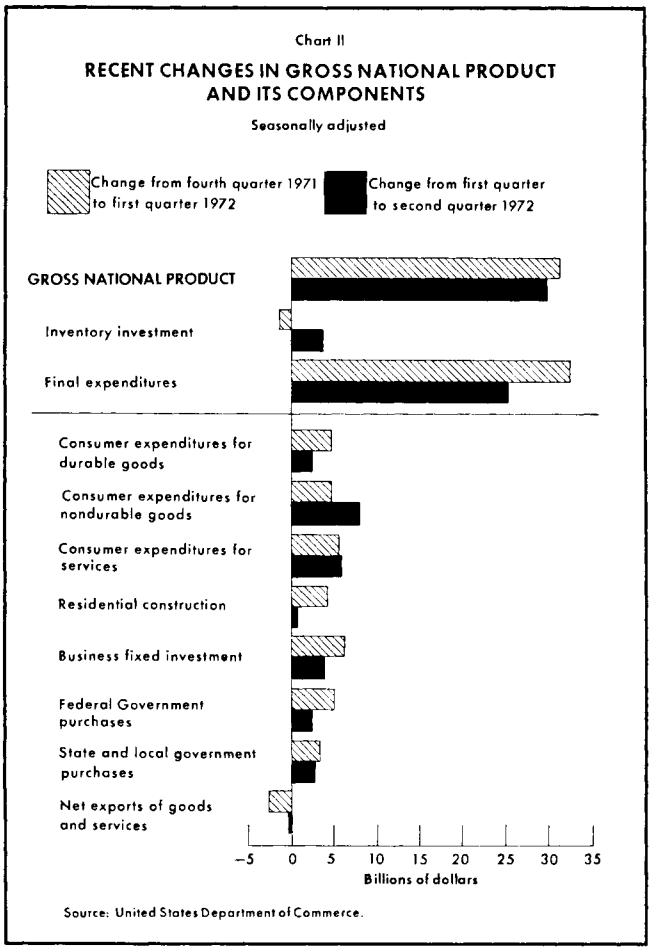
Chart I

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.



same gain that was posted in the preceding quarter. At the same time, the ratio of personal savings to disposable income declined for the fourth consecutive quarter to 6.6 percent.

The latest reading for the savings rate is the lowest since the fourth quarter of 1969 and is only slightly above its average for the entire post-Korean war period. While the overwithholding of personal income taxes has probably artificially depressed the savings rate in the last two quarters, it appears that even allowing for this effect there has still been a significant decline. For example, it is estimated that overwithholding increased Federal tax payments by approximately $8 billion at an annual rate in each of these two quarters. Even if all of this overwithholding were fully intentional, the implied value of the true savings rate in the April-June period would still be about 1 percentage point below the record 8.6 percent posted in the second quarter of 1971.

Business fixed investment grew by $4 billion in the second quarter, with the gain concentrated almost exclusively in producers' durable equipment. This increase, coupled with the extraordinary $6.3 billion rise in capital expenditures during the January-March period, brought the growth in the first half of this year to an annual rate of 19.6 percent. Moreover, recent data suggest continued strength in spending for new capital equipment in the months ahead, as new orders for nondefense capital goods rose sizably in both April and May and edged up further in June. In light of this evidence, it appears quite possible that the rise in plant and equipment expenditures for 1972 as a whole will surpass the 10.3 percent increase that was expected in the May survey of spending plans conducted by the Department of Commerce and may be closer to the 14 percent gain indicated in the McGraw-Hill spring survey. By comparison, plant and equipment expenditures rose by a small 1.9 percent in 1971.

Spending on residential construction increased by $0.8 billion over the April-June period. This was the smallest quarterly gain in almost two years, suggesting that the housing boom may be peaking out—albeit at a very high level. Housing starts in the second quarter averaged 2.2 million units at an annual rate, down from the unprecedented 2.5 million unit pace set in the January-March period. In addition, the second-quarter level of building permits was slightly below its average of the previous three-month period.

Government purchases of goods and services contributed $5.2 billion to the second-quarter GNP advance. Federal expenditures rose by $2.5 billion, about half the increase of the January-March period which was swollen by civilian and military pay raises. The bulk of the rise in Federal expenditures in the second quarter reflected an increase in defense spending. This increase brought Federal spending for defense to an annual rate of $78.6 billion, the highest level in more than two years. At the state and local levels, spending rose by $2.7 billion in the April-June period, down $0.8 billion from the increase of the previous quarter.

PRICES, WAGES, PRODUCTIVITY, AND EMPLOYMENT

With the exception of movements in the wholesale price index, recent price data confirm a definite easing of inflationary pressures. The slow advance of the consumer price index in the last four months is especially encouraging. Taking a somewhat longer perspective, June marked the first time since 1967 that the year-to-year change in this index was less than 3 percent. Moreover, the GNP de-

flator posted a relatively modest increase in the second quarter, although shifts in the composition of output caused some understatement of actual inflation.

According to preliminary estimates, the implicit GNP price deflator rose at a 2.1 percent seasonally adjusted annual rate in the second quarter, down sharply from the 5.1 percent rate of the January-March period. This comparison overstates the deceleration in the underlying pace of inflation since the first-quarter deflator was given a temporary boost by the post-freeze clustering of price increases and the Federal pay raises. Beyond this, the slowdown partly reflected shifts in the composition of output in the second quarter toward goods—such as producers' durable equipment—whose prices have risen less rapidly relative to the prices of others since the base year for the index. These shifts had a depressing effect on the deflator in the April-June period 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, a measure of prices which is not affected by changes in the composition of output between adjacent quarters, rose at a 3.2 percent annual rate in the second quarter, down from the 3.9 percent average gain posted over the preceding four quarters.

Recent movements in the consumer price index are encouraging. In June, consumer prices rose by only 0.7 percent on a seasonally adjusted annual basis. This small increase followed a 4 percent rise in May but very modest advances in the two preceding months. During the March-June period as a whole, increases in the consumer price index had averaged less than 1.8 percent per annum, the slowest advance in this index for any four-month period—including the months covered by the price freeze—in almost seven years. Overall, in Phase Two thus far, consumer prices have risen at an annual rate of 3.1 percent, down 0.7 percentage point from the pace of the first eight months of 1971 and substantially below the increases registered in each of the preceding three years when consumer prices rose annually between 4.7 percent and 6.1 percent. To some extent, this comparison may understate the recent deceleration in the advance of consumer prices, since increases that might otherwise have occurred during the price freeze tended to be bunched in the immediate post-freeze period. Thus, when the price-freeze and Phase Two periods are combined the slowdown is even more apparent (see Chart III).

The small June increase in the consumer price index resulted from virtually no change in prices of nonfood commodities as a whole, coupled with a 3.7 percent annual rise (not seasonally adjusted) in prices of services and a 2 percent gain in food prices. In the nonfood commodity group, the prices of some individual products—such as homes and used cars—moved up appreciably, but these increases were balanced by declines in the prices of apparel, gasoline, liquor, and fuel oil and coal. Within the service sector, mortgage interest rates moved up for the first time since October of last year and doctors' fees rose at a 6 percent annual rate. Not surprisingly, given recent movements in food prices at the wholesale level, retail prices of meats and poultry climbed sharply in June, and vegetable and fresh fruit prices also rose. In the light of the steep advance of wholesale food prices in July, the rise in consumer food prices seems likely to accelerate in coming months.

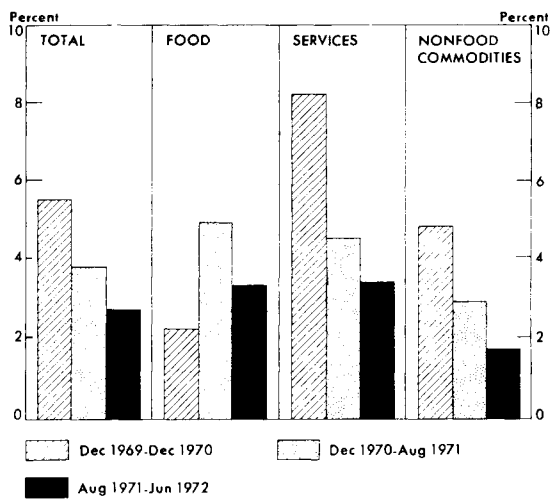
At the wholesale level, prices rose in July at a seasonally adjusted annual rate of 8.6 percent, the sharpest gain since August of last year. This huge July bulge mainly reflected a large increase in prices of farm products and processed foods and feeds which surged ahead at over a 24 percent annual rate. Livestock prices, particularly for hogs, and prices of fresh fruits, eggs, and poultry posted steep increases. At the same time, however, the rise in industrial commodity prices moderated to an annual rate of 2.8 percent.

July was the first month this year in which industrial commodity prices rose by less than 4 percent. While the rapid advance of such prices during the first few months of the year was expected in view of the post-freeze cluster-

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.

ing of price increases, the sharp increase of 4.5 percent posted in the second quarter remains somewhat disturbing despite the more moderate July increase. Overall, in Phase Two thus far, industrial commodity prices have climbed at an annual rate of 4.1 percent, down 0.6 percentage point from the rise in the first eight months of 1971 but 0.6 percentage point above the average gain registered in the 1968-70 period.

The pace of wage increases has slowed somewhat in recent months. Compensation per hour of work in the private economy rose at a 5.6 percent seasonally adjusted annual rate in the April-June period, down from an average increase of 6.5 percent over the previous four quarters. Average hourly earnings—one of the monthly sources for the series on compensation per hour of work—rose very rapidly in April, posted very small increases in both May and June, and then rose moderately in July. Moreover, the latest Bureau of Labor Statistics survey reveals some moderation in the rate of increase in wages and benefits under major collective bargaining settlements. For example, in the manufacturing sector the mean life-of-contract wage and benefit gain for settlements, covering 5,000 or more workers, negotiated from January through June was 6 percent in contrast to 7.7 percent in 1971. The slowdown was even more pronounced in the construction sector, where the increase in the average life-of-contract settlements for wage and fringe benefits was 7.6 percent in the first half of 1972, down sharply from last year's 12.1 percent gain. It should be noted, however, that this survey covers contracts involving only 616,000 workers for all industries and excludes wage settlements, involving 750,000 workers, which had not been acted upon by either the Pay Board or the Construction Industry Stabilization Committee. In addition, 1972 is a relatively light collective-bargaining year and a much heavier load of settlements is expected to be negotiated in 1973. Thus, the extent to which this recent slowdown in the pace of wage increases under collective bargaining agreements proves to be of a permanent rather than temporary nature depends in part on future decisions of the Pay Board and perhaps more fundamentally on whether price inflation is brought under control.

The growth of productivity, as measured by the index of output per hour of work in the private nonfarm economy, accelerated to a 4.8 percent seasonally adjusted annual rate in the second quarter. Including the farm sector, where productivity changes tend to be quite volatile on a quarterly basis, output per hour of work climbed at a 6.3 percent annual rate. This gain coming on the heels of the sizable advance in output per hour of work over the previous nine-month period brought growth in the second quarter from four quarters earlier to a rapid 4.4 percent, about 1.2 percentage points above its long-run trend. As a consequence of the substantial increase in productivity coupled with the moderation in compensation per hour of work, unit labor costs declined slightly in the second quarter for the first time in over six years. In contrast, unit labor costs climbed at an average annual rate of 6 percent over the 1968-70 period and rose by 2.2 percent in 1971.

According to the monthly survey of households, both civilian employment and the labor force were virtually unchanged in July, after adjustments for seasonal variations. As a consequence, the unemployment rate remained unchanged from June's level of 5.5 percent. Prior to these two months, the rate of unemployment had hovered near 5.9 percent since late 1970. Notably, the jobless rate for men twenty-five years of age and older declined in July by 0.3 percentage point to 3.0 percent, its lowest level in nearly two years. Jobless rates for teen-agers and men and women between twenty and twenty-four years of age rose during the month after posting declines in June. Following several months of sizable gains earlier in the year, the most recent survey of establishments indicates that nonfarm payroll employment was essentially flat for the second consecutive month. In July, employment in the construction and manufacturing industries was particularly weak. It should be noted, however, that the decline in construction employment in this month partly reflected an increase in strike activity. Also, according to the Bureau of Labor Statistics, employment in both construction and manufacturing seems to have been held back by the effects of tropical storm Agnes.

The Business Situation

On balance, it appears that economic activity is continuing to expand briskly, although not so fast as the exceptionally rapid pace of the second quarter.[1] Retail sales posted a substantial and broadly based gain in July. At the same time, personal income surged, but this reflected the artificial depression of the June level by losses connected with the severe flooding in the East that accompanied tropical storm Agnes in late June. The storm also apparently caused a decline in inventories at wholesale and retail outlets in June. In the manufacturing sector, however, inventories advanced sharply in both June and July. Industrial production registered only small gains in both of these months, as output was undoubtedly held back to some extent by the storm. While employment rose strongly in August, the unemployment rate was virtually unchanged from the level of June and July, remaining significantly below the level that had prevailed since late 1970.

Recent data confirm that the pace of wage increases has slowed appreciably. For example, over the seven months ended in August, average hourly earnings of production and nonsupervisory workers in the private nonfarm economy advanced at a rate significantly slower than that posted over the past several years. The rise in consumer prices has also moderated thus far this year, although there was a spurt in food prices in July. The advance in prices of services and nonfood commodities, however, continued at a moderate pace by comparison with the experience of recent years.

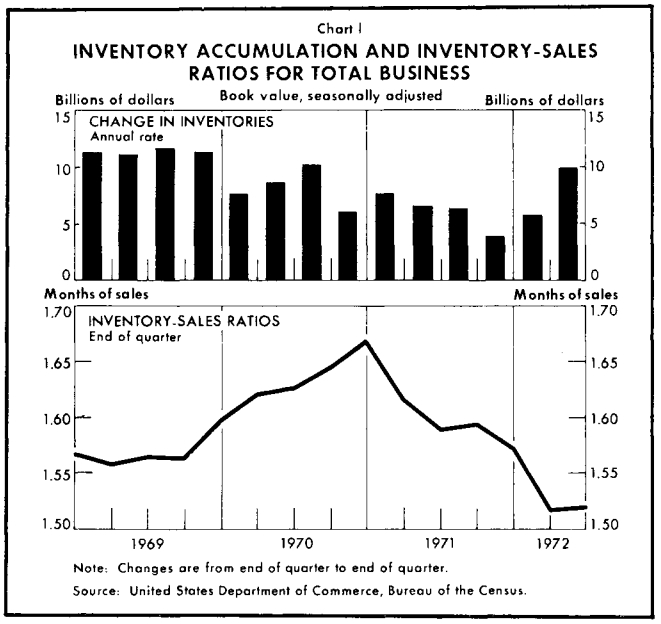
[1] The second-quarter estimate of growth in real gross national product (GNP) has been revised upward from 8.9 percent (seasonally adjusted annual rate) to 9.4 percent—the largest quarterly percentage gain in real GNP since the fourth quarter of 1965 and, except for that quarter, the highest in thirteen years. Measured in current dollars, revisions in preliminary GNP and its components were small. The increase in the implicit GNP price deflator was revised downward to an estimated 1.8 percent annual rate from the 2.1 percent originally reported. Profits before taxes in the second quarter advanced $4.9 billion. This was about the same as the gain of the previous quarter despite the effects of flooding in June, which the Department of Commerce estimates reduced second-quarter profits by approximately $1.8 billion.

PRODUCTION, ORDERS, AND INVENTORIES

According to preliminary data, the Federal Reserve Board's index of industrial production edged up at a 3.2 percent seasonally adjusted annual rate in July, following a downward revised increase amounting to only a 1.1 percent annual rate in the preceding month. While these gains were considerably smaller than those posted earlier in the year, it appears likely that this slowdown reflects in part the effects of severe flooding in late June rather than any pronounced weakening in the economic advance. Along with the release of the July estimate, revised readings of industrial production for the months March through May were presented. During this period, increases in output are now estimated to have averaged 11.6 percent per annum, about 3 percentage points more than was previously reported. These latest figures bring growth in the industrial production index over the seven months ended in July to a very rapid 8.7 percent annual rate, in marked contrast to the annual rate of gain of only 1.1 percent in the preceding seven-month period.

Sharp increases in the production of materials have been one of the major elements contributing to the overall expansion in output so far this year. In July, materials production climbed at a 5.2 percent annual rate, with the gain distributed among equipment parts, industrial fuel and power, and textiles, paper, and chemicals. Over the first seven months of the year, materials output has risen at a very robust annual rate of 12.3 percent. Similarly, output of defense and space equipment has increased substantially thus far in 1972, following a period of prolonged decline. However, despite recent gains, such output remains about 27 percent below its peak reached in mid-1968. Consumer goods production was unchanged in July, although output of household goods, after adjustment for seasonal variations, continued to rise rapidly. Business equipment output, which had increased strongly earlier in the year, declined slightly for the second consecutive month. To a considerable extent the decrease in such output in July was probably flood related.

New orders placed with manufacturers of durable goods dropped $1 billion, or 2.8 percent, in July following the



surge in June. The decline in July, like the previous month's rise, was centered in bookings of defense capital goods. Excluding such goods, new durables orders posted a moderate gain in July. Orders for nondefense capital goods were virtually unchanged, however, after substantial gains earlier in the year. Orders for capital goods have a considerable lead time over spending, and hence it appears that investment spending should continue to expand strongly in the months ahead despite the failure of new orders for these goods to rise further in July. Such an outcome would be consistent with the results of the latest Commerce Department survey of plant and equipment spending intentions, which was conducted during July and August. While expenditures on plant and equipment in the second quarter fell short of projected levels, firms were planning sizable increases in their expenditures during the second half of 1972. For the year as a whole, the survey indicates a substantial gain of 9.7 percent, down slightly from the 10.3 percent rise projected in the April-May survey. By comparison, plant and equipment outlays edged up by less than 2 percent in 1971.

After a long period of very sluggish growth, total business inventories, on a book value basis, advanced at a $9.9 billion seasonally adjusted annual rate in the April-June period, the largest quarterly gain in almost two years (see Chart I). Much of this second-quarter strength in inventory spending was concentrated in May. In June, aggregate inventory accumulation came to only $6.4 billion at an annual rate, less than one half the expansion of the preceding month. While manufacturers' inventories registered a sizable gain in June (and, according to preliminary data, in July as well), retail stocks edged down and wholesalers cut their holdings in June by more than $1.4 billion on an annual rate basis. Inventory spending may have been held back significantly in that month by the tropical storm which affected much of the East Coast. The storm probably hampered production of goods that otherwise might have gone into inventories. Moreover, businessmen seem to have promptly written off large quantities of damaged goods from their books, thus directly erasing some inventories from the total. Business sales were also relatively weak in June, falling at an annual rate of $7.7 billion. Over the April-June period as a whole, combined sales in manufacturing and trade advanced at a $5.9 billion annual rate, somewhat slower than the expansion of inventories. As a consequence, the inventory-sales ratio for all businesses reached 1.52 in June, up marginally from the level attained at the end of the first quarter but still below the 1.59 ratio prevailing a year earlier. The persistently low level of the inventory-sales ratio suggests that inventory spending may strengthen further in the months ahead as sales continue to expand.

PERSONAL INCOME, RETAIL SALES, AND RESIDENTIAL CONSTRUCTION

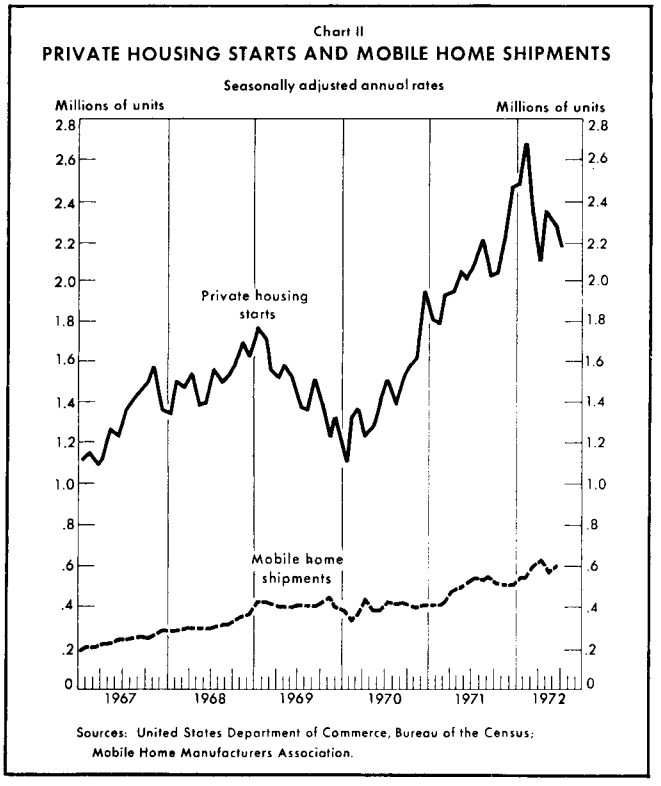
Personal income rose by a substantial $11.3 billion in July, after dropping by $1.1 billion in the preceding month. Both the July spurt and the June decline largely reflected the effects of Hurricane Agnes. Huge capital losses—representing damage to residential structures and proprietors' plant and equipment and inventories—were written off in June, so that rental and proprietors' income in that month fell by $6.5 billion. Since this was largely a once-and-for-all effect, such income rebounded by $7.0 billion in July. Excluding rental and proprietors' income, personal income increased by $4.3 billion in July, about $1 billion below the average monthly gain registered in the second quarter. Wage and salary disbursements—the principal component of personal income—rose by only $2.4 billion, down from an average monthly advance of $4 billion in the April-June period. The small July increase in wage and salary disbursements resulted largely from a decline in payroll employment which, in turn, stemmed partly from several strikes in the construction industry in addition to the effects of tropical storm Agnes.

According to an advance estimate, retail sales climbed by a brisk 1.9 percent in July. The rise was broadly based, as sales of durables and nondurables shared in the gain.

Automobile sales accounted for most of the strength in durables. Sales of new domestic-type automobiles accelerated to a seasonally adjusted annual rate of almost 10 million units in July, the fastest pace since last October when demand was stimulated by the price freeze. Sales of imported cars were at a 1.6 million unit annual rate, about the same rate that has prevailed on average over the past eighteen months.

During the first seven months of this year, total retail sales advanced at an annual rate of 12 percent, 2 percentage points above the gain registered in 1971 and 7 percentage points above the rate of increase posted in 1970. Moreover, thus far in 1972 consumer prices have risen at a slower pace than that experienced in the past several years. Hence, a smaller fraction of the recent gains in consumer spending has been accounted for by price increases. Prospects for further strong gains in consumer spending in the months ahead appear to be good, particularly in light of the increase in social security benefit payments beginning in October.

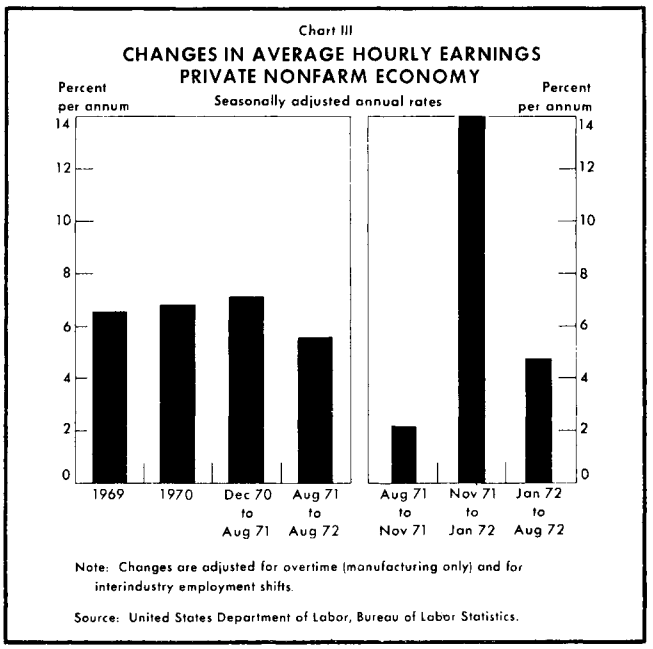
Recent data confirm that the rate of residential construction, which was exceptionally strong earlier in the year, has begun to taper off to some extent. Private housing starts have declined irregularly since reaching a peak of 2.7 million units at a seasonally adjusted annual rate in February (see Chart II). During July the number of housing starts dropped by 100,000 units from the June reading to an annual rate of 2.2 million units, about 19 percent below the February level. Moreover, the inventory of unsold single-family homes in the hands of the nation's builders has risen sharply in the last several months, suggesting that a further decline in residential construction activity may be in the offing. On the other hand, it should be noted that, despite the decline in starts in recent months, they still remain high by historical standards. For example, July marked the fifteenth consecutive month that starts have exceeded 2 million units at an annual rate. By comparison, over the decade of the 1960's, housing starts averaged 1.4 million units per year and, in early 1970 following a period of monetary restraint, the annual rate of starts stood as low as 1.1 million units.



While housing starts have moderated in recent months, shipments of mobile homes have continued near their record pace set earlier in the year. In June, the latest month for which data are available, shipments on an annual rate basis advanced 32,000 units to 604,000 units. In longer run perspective, mobile home sales have risen sharply from 104,000 units in 1960 to an annual rate of 585,000 units during the first half of this year, as such homes have become increasingly popular both for recreation and as permanent residences. Combining mobile home sales and the pace of housing starts, total housing units were apparently being added at close to a 3 million unit annual rate in the first half of the year, compared with an average yearly rate of 1.6 million units during the 1960's.

EMPLOYMENT, WAGES, AND PRICES

Nonagricultural payroll employment rose sharply in August after remaining essentially flat in the two preceding months. According to the Bureau of Labor Statistics survey of employers, about 280,000 workers were added to nonfarm payrolls on a seasonally adjusted basis, a substantial 4.6 percent annual rate of increase. The gain was broadly based although manufacturing employment, which had been depressed in July by the effects of tropical storm Agnes, merely recovered to its June 1 level after posting substantial gains over the first half of the year. Taking a somewhat longer view, nonfarm payroll employment has risen by a rapid 3.3 percent since August 1971. In contrast, during the preceding nine-month period beginning November 1970—the month tentatively identified by the National Bureau of Economic Research as marking the trough of the 1969-70 recession—employment advanced at an



annual rate of only 1 percent.

The most recent survey of households indicates that civilian employment also rose sharply in August, advancing by 290,000 workers on a seasonally adjusted basis—the largest monthly increase in five months. At the same time, the civilian labor force also rose very rapidly by 390,000 workers. Consequently, the unemployment rate edged up to 5.6 percent from the 5.5 percent level of June and July. Prior to these three months the rate of unemployment had hovered near 5.9 percent since late 1970. While the overall unemployment rate has remained virtually steady since June, there have been significant changes in its composition. The decline in the rate of unemployment in June was almost entirely accounted for by a drop in joblessness among teen-agers and men and women between twenty and twenty-four years of age. This, in turn, stemmed partly from a much smaller than seasonal influx of young people into the labor force. Since June, jobless rates for young people have risen, particularly the rate for teen-agers which now stands above its May reading. Meanwhile, the unemployment rate for persons twenty-five years of age and older fell significantly in July and moved slightly lower in August as well, extending further the gradual downturn evident since the end of last year. Notably, the rate of unemployment for married men declined from 2.9 percent in June to 2.6 percent in August, its lowest level since mid-1970.

The pace of wage increases has slowed appreciably in recent months. In August, seasonally adjusted 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 modest 4.4 percent annual rate. Since August 1971—the inception of wage and price controls—earnings have advanced by 5.6 percent, substantially below the increases registered in the past several years when earnings rose annually at rates close to 7 percent (see Chart III). Increases in earnings have varied considerably over the past year. During the wage-price freeze from August to November 1971, earnings rose very modestly but then spurted at an annual rate of 14 percent in the two succeeding months, largely as a result of a clustering of wage increases that would otherwise have occurred during the months covered by the freeze. Over the seven months following January, the increase in earnings has slowed to an annual rate of 4.8 percent.

The consumer price index climbed at a 5.1 percent seasonally adjusted annual rate in July, the sharpest increase in five months. Almost two thirds of the July rise resulted from higher prices of food, which surged ahead at an annual rate of more than 7 percent. Meat prices showed the steepest advances, but there were also increases in prices of eggs and fresh fruits and vegetables. The large July rise in consumer food prices had been presaged by recent price developments at the wholesale level. Prices of farm products and processed foods and feeds, for example, advanced at about a 6 percent annual rate in June and then jumped by over 24 percent per annum in July. Since changes in wholesale prices are often reflected in prices of consumer goods with a lag, it seems likely that consumer food prices will continue under upward pressure in the near term. In July, prices of nonfood commodities at the consumer level advanced at a 3.1 percent annual rate while prices of services (not seasonally adjusted) rose at an annual rate of 3.7 percent. Both increases were slightly above those registered over the first half of the year.

In the eleven months since wage and price controls were first introduced in August 1971, consumer prices as a whole have risen at an annual rate of 2.9 percent, compared with increases of 6.1 percent in 1969, 5.5 percent in 1970, and 3.8 percent over the January-August 1971 period.

The Business Situation

The broadly based expansion in economic activity appears to be continuing. Almost every sector of the economy has lately displayed either renewed or extended strength. Construction of residential housing spurted in August, after having declined somewhat in previous months. At the same time, inventory spending by manufacturers strengthened somewhat, and new orders for durable goods also advanced. Retail sales increased vigorously in July and August, although preliminary reports point to a decline in September. These developments were accompanied by widespread increases in industrial production and additional gains in employment. In September, the seasonally adjusted unemployment rate edged down to 5.5 percent, reversing the slight increase in the previous month.

The latest data indicate comparatively moderate gains in wages and prices, extending the improved performance of recent months. In August, the rate of increase in consumer prices slowed markedly after spurting in the previous month. Consumer food prices, however, posted another sizable increase in August and remain a source of some concern. The most encouraging development on the price front has been the recent slowdown in the climb of wholesale industrial prices. Between June and September, these prices increased at an annual rate that was almost a percentage point below the 4 percent or higher growth that had characterized the earlier part of Phase Two.

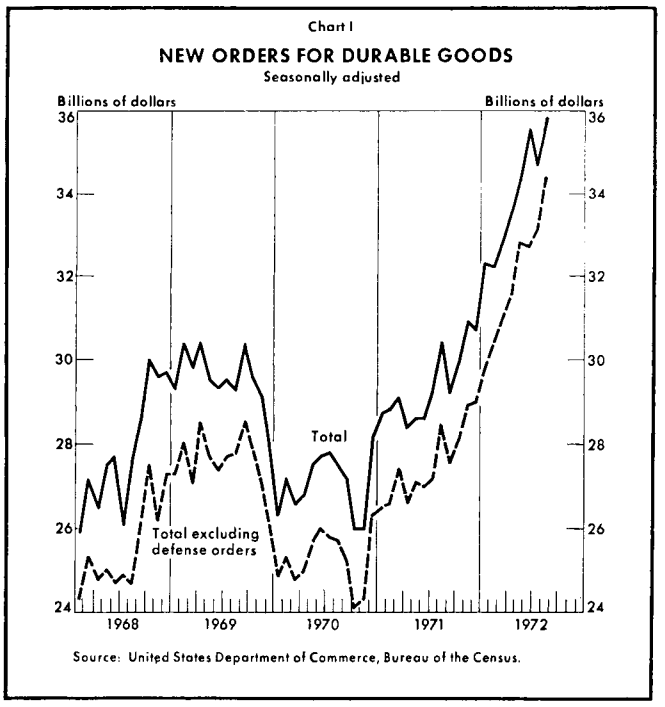
INDUSTRIAL PRODUCTION, ORDERS, AND INVENTORIES

According to the latest estimates of the Board of Governors of the Federal Reserve System, industrial production expanded in August at a seasonally adjusted annual rate of 6.3 percent, rising to a level 114.3 percent of the average for 1967. Although this was the largest increase since April, it was only about half as big as the growth in the opening three months of the year. Nevertheless, the August advance was widely distributed among market groupings. Output of business equipment rebounded sharply in August from its slightly depressed level of the previous two months and grew as fast as it had in the first five months of the year. Similarly, the production of defense and space equipment and of materials rose sizably, and there was also an increase in the output of consumer durable goods. In part, the slower expansion of total industrial production in recent months has reflected the reduced output of automotive products, which had grown at a 25 percent annual rate over the first four months of the year. While the production of motor vehicles and parts inched up in August, it remained 3 percent below its extremely high level of last April. Assemblies of domestically produced passenger cars have been fairly constant since June at a seasonally adjusted annual rate of about 8.5 million units, almost 0.5 million units less than the April peak.

Despite the slower growth of industrial production during midsummer, it still increased at an annual rate of 8.6 percent over the first two thirds of the year, much faster than the expansion in the second half of 1971. This acceleration was concentrated in the key manufacturing sector. Between last December and August, manufacturers' output rose at a seasonally adjusted annual rate of 10.5 percent, after having been virtually constant during the previous six months. Associated with this stepped-up activity in manufacturing has been a rise in the utilization of productive capacity. According to the Federal Reserve Board's quarterly estimates, the rate of capacity utilization jumped more than 2 percentage points during the first half of the year, reaching a level of 76.7 percent in the second quarter. Though this was the largest increase in any six-month period since the first half of 1966, the current level is still far below what it was in the mid-1960's. Indeed, throughout 1966, capacity utilization exceeded 90 percent. Other estimates of capacity utilization in manufacturing, compiled independently by McGraw-Hill from survey data, indicate that the remaining slack is widely distributed throughout the manufacturing sector.

In August, new orders for durables rose by slightly more than $1.2 billion, a seasonally adjusted gain of 3.6 percent. Large increases in orders for household durable goods and primary metals accounted for most of the advance in that month. The August rise more than reversed the decline of the previous month, which had been mainly

the result of a drop in bookings for defense goods. While defense orders are probably no less important than other durables orders for near-term output and employment, their volatility tends at times to obscure, and to be unrelated to, the underlying economic situation. If defense bookings are excluded, it then becomes evident that new orders for durable goods have been surging throughout the year (see Chart I). Over the eight months ended in August, new durables orders other than defense swelled at over a 26 percent annual rate—more than two times faster than the growth experienced during 1971. In large measure, this upsweep was centered in orders for durable consumption goods and for producers' capital goods. Shipments of durable goods rose by almost $0.8 billion in August, after adjustment for seasonal variation, up from the $0.4 billion average monthly increment during the year ended in July. However, these shipments were again less than new bookings for durables, and the excess was added to the stock of unfilled orders. Between December and August, the backlog of unfilled durables orders increased at a rapid 14.6 percent seasonally adjusted annual rate. Since many manufacturers of durables only produce goods for which they have advance bookings, the steady growth in unfilled orders for durables in recent months would appear to suggest a further expansion of output in the durables manufacturing sector over the next few months.



In line with the recent gains in production and orders, manufacturers have increased somewhat their spending on inventories. In August, the book value of manufacturers' inventories spurted $8.2 billion on a seasonally adjusted annual rate basis. (These figures are preliminary estimates, which have at times in the past been revised substantially.) Following their slight rundown in 1971, these inventories have advanced in all but one month of the current year, with especially large increments during the summer months. It should be noted, though, that these increases in book-value inventories have not been evenly distributed among stocks at all stages of fabrication. All of the large August buildup in inventories was confined to the stocks of finished goods and of goods in process. The book value of materials and supplies declined in that month, prolonging the downtrend of the past year. The apparent unwillingness of manufacturers to add to their stockpile of materials and supplies underscores the rather cautious attitude toward inventory investment that they have displayed throughout the recovery period. Consistent with this attitude is the persistent downtrend in the manufacturers' inventory-sales ratio during the last year and a half.

Wholesale and retail trade establishments have not seemed any more eager to step up their inventory investment than have manufacturers. The book value of total trade inventories increased at an annual rate of $5.4 billion in the second quarter, only a slightly more rapid rate than the average over the previous year. In July, the latest month for which these data are available, wholesalers expanded their stocks at a $4.9 billion annual rate. Retail stocks, on the other hand, fell as automotive dealers' holdings of 1972 cars declined in the face of strong sales. Excluding automotive products, retail trade inventories increased at an annual rate of about $1.3 billion in July.

PERSONAL INCOME AND RETAIL SALES

Personal income advanced $6.9 billion in August, slightly larger than the average gain of $6.1 billion for the first seven months of the year. An increase of $5 billion in wage and salary disbursements accounted for much of the August rise and largely reflected hikes in average hourly earnings. More than half of the increment in payrolls occurred in the commodities-producing sector, following the $1 billion decline in the previous month.

Seasonally adjusted retail sales were almost $550 million lower in September than in August, according to preliminary data which have often been revised considerably in the past. A fall in consumers' automotive spending accounted for most of the September decline. Since unit sales of

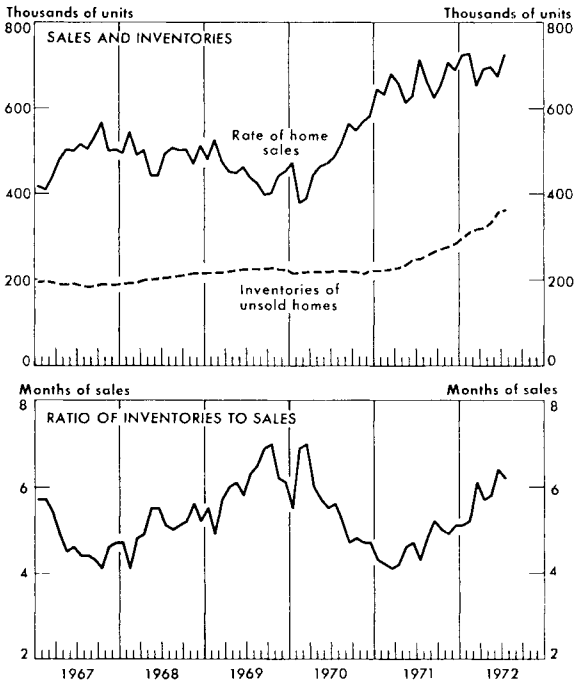
domestically produced automobiles were reported to have increased substantially in that month, the reported drop in automotive retail sales may partly reflect seasonal adjustment problems. Indeed, prior to September, total retail sales had grown at a very fast rate. Between April and August, retail sales of durables spurted at an annual rate of 21 percent, up from the 17 percent growth over the first third of the year. Also, sales of nondurables grew steadily at a rate slightly below 10 percent per annum over the first eight months of the year.

Consumption spending should receive additional stimulus in the months ahead from recent legislation that provided for a 20 percent increase in social security benefits beginning October 1. This will amount to an increase in benefits payments of about $8 billion at an annual rate. The Congress also provided for a rise in both the social security tax rate and the base of taxable income, which will not become effective until next year. Even then, however, these increases are unlikely to offset fully the effect of the larger benefits payments on consumption spending. Moreover, the overwithholding of individuals' income taxes during the current year will considerably boost disposable income when it is refunded by the Treasury in the first half of next year. It has been estimated that withholdings for 1972 could exceed income tax liabilities by as much as $8 billion. To be sure, only a portion of this will enter the spending stream, since some individuals have undoubtedly been treating these funds as a form of savings and, upon receipt of their refunds, will either transfer them into other forms of financial savings or perhaps use them to repay outstanding debts. But others will use their refunds to purchase additional goods and services.

Chart II

SALES AND INVENTORIES OF SINGLE-FAMILY HOMES

Seasonally adjusted



Note: New home sales are expressed as an annual rate; the inventory of unsold homes is the stock at the end of the month.

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

RESIDENTIAL CONSTRUCTION

Residential construction activity was quite vigorous in August, as housing starts spurted 12.2 percent to a seasonally adjusted annual rate of 2.46 million units. Large increases were posted in the starts of both single-family and multi-unit housing, after some easing in the spring and early summer. Newly issued building permits reached a new record in August, surpassing the previous peak established in January 1972.

Builders added comparatively few units to their inventories of new unsold one-family homes in July. The number of unsold units rose at a 17 percent seasonally adjusted annual rate in that month. While these stocks have been increasing since the beginning of 1971 (see Chart II), they gained momentum during the first half of the year when the stock of unsold homes swelled at an annual rate of 51 percent. No comparable buildup has occurred since these statistics were first collected in 1963. Sales of new one-family homes were at a seasonally adjusted annual rate of 724,000 units in July. Although this represented a large increase from the depressed June level, sales of new homes in July were only slightly above the average of the preceding year. With new-home sales holding rather steadily, the accumulation of unsold homes has resulted in a rise in the inventory-sales ratio. At the end of July, such inventories equaled 6.2 months of sales, up from the average ratio of 5.2 months over the year ended in June. This rising trend raises some doubts that the August level of housing starts will be sustained in coming months.

EMPLOYMENT AND PRICES

Conditions in the labor market continued to show signs of improvement in September. Reversing the movement of the previous month, the seasonally adjusted unemployment rate edged down 0.1 percentage point to 5.5 percent. This

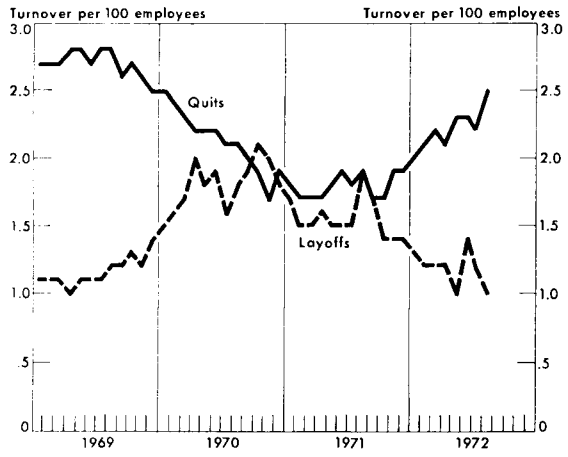
was the same level that prevailed in both June and July and was well below the 5.9 percent rate of unemployment which had persisted on average over the first five months of 1972. Civilian employment has increased rather steadily at a healthy 3 percent annual rate over the past three quarters, and the growth of the civilian labor force has only been slightly less rapid.

The payroll survey data for September also point to some further tightening in the labor market. Slightly more than 240,000 workers were added to nonfarm payrolls in that month, a seasonally adjusted annual rate increase of 4 percent. Additions to the work force in the manufacturing, government, trade, and finance sectors accounted for most of the September advance. Since the beginning of the year, the number of workers employed in the nonagricultural sector is now reported to have grown at a 3.8 percent annual rate, more than triple the rate of increase in 1971. Even in the face of these large gains in employment, wages have adhered to a comparatively moderate pace. In September, the average hourly earnings of workers in the private nonfarm economy—adjusted for overtime hours in manufacturing and for interindustry shifts in employment—rose at a 4.3 percent seasonally adjusted annual rate, about the same as the average increase between January and August.

Of the many sectors that have contributed to the speed-up in employment growth this year, the expansion in manufacturing is particularly notable. Over the first three quarters of this year, about 450,000 additional workers were employed in this sector, a 3 percent seasonally adjusted annual rate gain, whereas last year this employment actually declined. The sizable growth in manufacturing employment is only one facet of the improvement in labor market conditions, which has been underscored by the substantial changes in labor turnover rates. Within this sector, job vacancies and the rate at which workers have been hired have soared since the beginning of the year. Similarly, the quit rate in manufacturing — the number of workers who quit their jobs during the month per 100 employees—has risen dramatically in recent months in line with the increase in job opportunities (see Chart III). This has coincided with a marked drop in the layoff rate—the number of workers laid off in a month per 100 employees. As a result, the gap between the quit and layoff rates has widened progressively over the year, reflecting the tightening in the labor market. Indeed, in August, the combination of a large increase in the quit rate and fall in the layoff rate stretched the gap between them to the widest level since August 1969.

The latest readings on inflation are fairly encouraging. Consumer prices rose at a seasonally adjusted annual rate of 3 percent in August, well below the July spurt and about equal to the rate of growth prevailing since the inauguration of the wage and price controls in August 1971. Indeed, the August performance would have been somewhat better but for the continued rapid run-up in retail food prices. The advance of services prices slowed somewhat further, while prices of nonfood commodities rose a bit more rapidly than they had in the two previous months. On the whole, these increases remained relatively modest. Perhaps the most favorable development on the inflation scene was the small increase in wholesale prices in September, when the index climbed at a 3.6 percent seasonally adjusted annual rate, considerably lower than the advance in the previous two months. Though wholesale prices of farm products and processed foods and feeds increased at a 9.6 percent annual rate during the month, this nevertheless represented a substantial reduction from the pace of July and August. At the same time, wholesale industrial prices advanced at a 2.4 percent annual rate, the slowest rise in ten months. Over the July-September period, these prices have thus increased at a 3.2 percent annual rate, an improvement relative to the persistent pattern of increases of 4 percent or more that has characterized Phase Two as a whole.

Chart III
QUIT AND LAYOFF RATES IN MANUFACTURING
Seasonally adjusted



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

The Business Situation

Recent business statistics indicate that the economy is continuing to move ahead briskly. Real gross national product (GNP) increased at an annual rate of 5.9 percent in the third quarter. While this gain was smaller than the exceptionally large advance in the preceding quarter, the reduction in the rate of growth was confined mainly to inventory investment and defense spending and does not seem to indicate any weakening in the underlying economic situation. Consumers, businesses, and state and local governments all vigorously expanded their demands for goods and services. Surveys of consumer sentiment, moreover, suggest a marked improvement in confidence in recent months. New orders for durable goods, capital appropriations, and plans for investment in plant and equipment further point the way to continued robust economic activity. Indeed, a large gain in employment occurred in October, although a similarly large increase in the labor force held the unemployment rate unchanged at 5.5 percent.

On the price front, the course of inflation has apparently changed little recently, as prices continue to rise at comparatively moderate rates. The fixed-weight price deflator for total GNP increased at a 2.9 percent annual rate in the third quarter. The consumer price index, however, rose at a somewhat faster rate in the third quarter than in the first half of the year, reflecting in part the large September increase. Much of this acceleration was a result of the run-up in food prices. On the other hand, there was a noticeable easing in the rate of rise in wholesale industrial prices in the third quarter. The situation improved even further in October, when industrial prices actually fell slightly.

GROSS NATIONAL PRODUCT AND RELATED DEVELOPMENTS

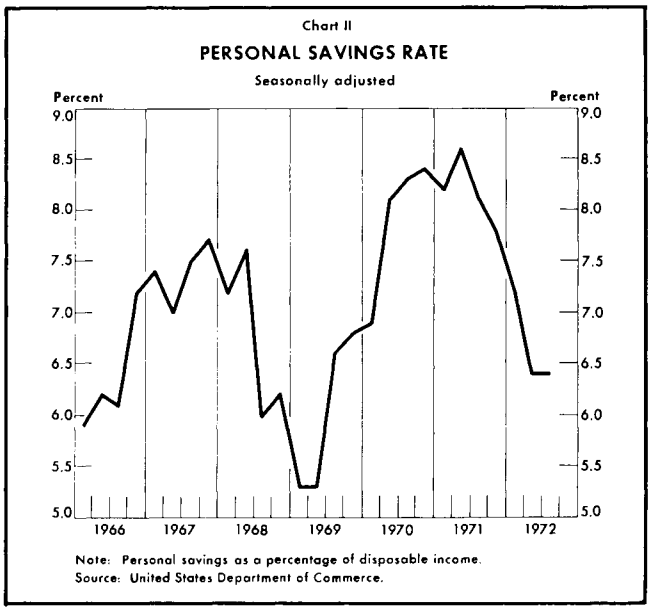
Preliminary estimates prepared by the Department of Commerce indicate that the total market value of the nation's output of goods and services rose $22.8 billion in the third quarter, an 8.3 percent seasonally adjusted annual rate of gain. Only about one fourth of this advance, moreover, was the result of higher prices. Valued in terms of 1958 prices, output of goods and services (real GNP) expanded at a 5.9 percent annual rate during the third quarter. This was still a sizable advance, even though it was overshadowed by the exceptionally large 9.4 percent rate of rise in real GNP in the preceding quarter. Over the last four quarters, the real growth has been an impressive 7.1 percent, slightly more than twice the average increase between 1953 and 1971.

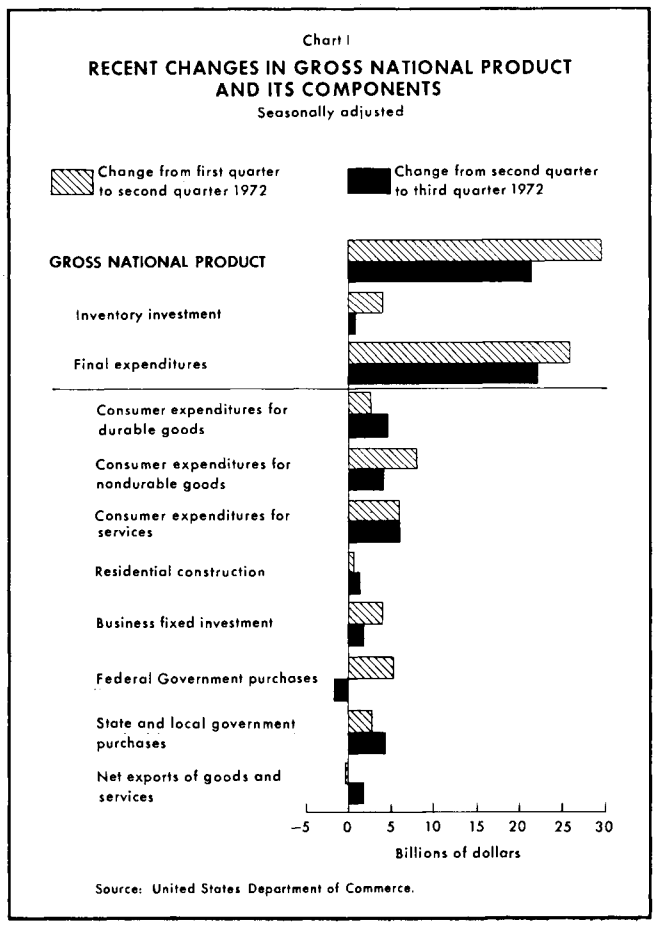
The reduction in the rate of GNP growth in the third quarter was centered mainly in inventory investment and in defense spending by the Federal Government, both of which had shown quite large increases in the preceding quarter. Indeed, final expenditures on nondefense goods and services actually rose slightly faster in the July-September period than they had in the previous three months. This increase in final spending, moreover, was widely distributed throughout the economy (see Chart I).

Inventory investment is tentatively reported to have contributed a very modest $0.7 billion to the increase in GNP in the third quarter, down markedly from the $4.6 billion rise in the previous three months. This comparison, however, obscures the turnabout in inventory spending that has occurred in recent months. Nonagricultural businesses added $5.3 billion worth of goods to their inventory stocks in the third quarter, following an only slightly smaller addition during the previous three months. The accumulations in these two quarters together exceeded those of the preceding four combined. To a considerable degree, this quickening in the pace of inventory spending has reflected developments within the manufacturing sector. After running down their inventories throughout 1971, manufacturers began to enlarge their stocks at the start of the current year, with the increment in each quarter exceeding that of the previous one. At the same time, wholesale and retail establishments have also been stepping up the pace of their inventory spending, albeit somewhat cautiously. Nevertheless, the increases in the book value of total business inventories have remained proportionately smaller than those in total business sales, and the inventory-sales ratio has continued

to trend downward. In August, the latest month for which data are available, this ratio declined to 1.48 months of sales, the lowest level since mid-1966.

Consumption spending again climbed vigorously in the third quarter. Personal consumption expenditures rose by a sizable $14.7 billion over that period, a seasonally adjusted annual rate of increase of 8.5 percent. Although this was off somewhat from the advance during the first half of the year, it still constituted a healthy gain. Looking at the first nine months of the year as a whole, the rises in expenditures on consumer durables, nondurables, and services were all considerably larger than they had been in the preceding three quarters. Indeed, the rapid expansion in consumption spending this year has been a major underpinning of the faster pace of the recovery in economic activity. Moreover, results of the latest consumer surveys, which attempt to plumb consumers' attitudes directly, point to a marked improvement in confidence and buying plans in recent months.





The third-quarter moderation in the growth of personal consumption expenditures was accompanied by a leveling-off in the personal savings rate. After falling precipitously from its peak of 8.6 percent of disposable income in the second quarter of 1971 to 6.4 percent in the corresponding quarter this year, the savings rate was unchanged at this level in the July-September period (see Chart II). Inasmuch as disposable income tends to be rather closely linked to GNP, the decline in the savings rate underscores the important role that the growth of consumption has played in the overall expansion in economic activity during the year. It should be noted, however, that the overwithholding of personal income taxes may be artificially depressing the savings rate to some extent. Some estimates have placed the amount of overwithheld taxes at around $8 billion, and some individuals may be treating these funds as a form of saving.

Expenditures on residential construction edged up $1.4 billion in the third quarter. Though this increase was a bit larger than that of the previous quarter, it remained well below the gains of the preceding year and a half. This apparent leveling-off in the growth of spending on residential structures, which had been widely anticipated, reflected a peaking-out in the rate at which new homes were begun in earlier months of the year. Since work progresses on a new housing unit for some time after construction is begun, expenditures tend to continue upward even after housing starts have turned downward. During the opening

three months of the year, housing starts soared to a new record, averaging 2.5 million units at a seasonally adjusted annual rate. While starts in each of the succeeding six months were below the first-quarter average, they remained quite strong by historical standards. In the third quarter, for example, the average number of housing units started was only 7 percent below that of the January-March period.

Business expenditures on fixed investment goods rose by $1.9 billion in the third quarter, well below the $4.3 billion increase averaged in the preceding nine months. Over the first three quarters of the year, these outlays have grown at a 14 percent seasonally adjusted annual rate, up from the 11.5 percent rise recorded in 1971. These expenditures data, moreover, understate somewhat the strengthening in the demand for fixed investment goods, as they usually do during an extended upswing. This arises because of the lags separating decisions to begin new investment projects, the initiation of work on these projects, and final completion of the projects. Quarterly data on capital appropriations and expenditures of the nation's 1,000 largest manufacturers collected by The Conference Board are available through the second quarter of this year. During the first half of the year, these companies expanded their net new appropriations at close to a 40 percent annual rate, adding substantially to the backlog of unspent appropriations. Similarly, Commerce Department data indicate that the growth in new orders for nondefense capital equipment has outpaced that of shipments of these goods over the first nine months of the year, and consequently the backlog of unfilled orders for these goods has risen. Recent survey data suggest that this substantial demand for fixed investment goods will extend into next year as well. The latest Lionel D. Edie & Company Inc. survey of intended plant and equipment spending in 1973 calls for a 10 percent increase above the 1972 level, while the McGraw-Hill survey indicates an 11 percent increase in expenditures planned for 1973.

Government purchases of goods and services contributed only $2.5 billion to the rise in current-dollar GNP in the third quarter, the smallest gain in over a year. At the Federal level, a large decrease in defense spending swamped spending increases for other goods and services and fully accounted for the slowdown in total government expenditures. State and local governments, on the other hand, raised their expenditures by a sizable $4.4 billion in the third quarter. The recent passage of revenue sharing may further bolster spending by state and local governments in coming quarters, though some Federal funds may be used to replace other financing by the local authorities and would not lead to additional spending.

PRICE DEVELOPMENTS

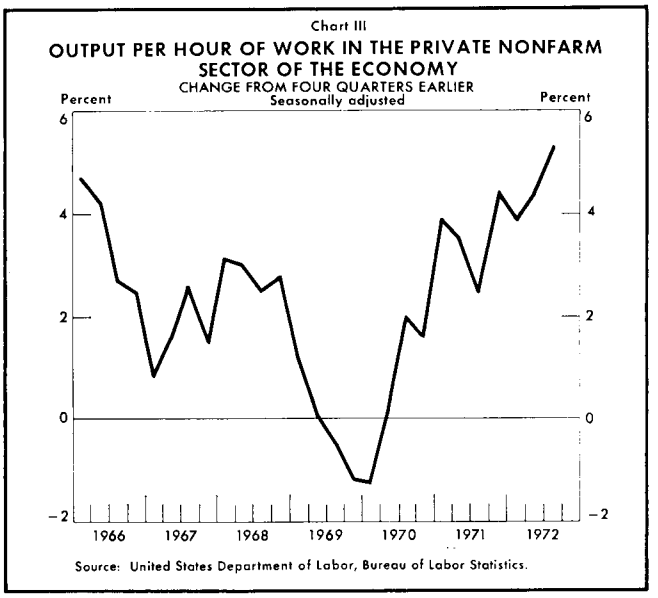
The various price indicators continue to show mixed—though, on balance, encouraging—results. In general, it appears that prices have been rising in recent months at much slower rates than during the period preceding the inauguration of the Economic Stabilization Program in August 1971. At the same time, however, there is no clear-cut evidence that inflation has lately slowed further from the rates that had prevailed earlier this year.

According to preliminary estimates, the implicit price deflator for total GNP advanced at a 2.2 percent seasonally adjusted annual rate in the third quarter. This rise was a bit higher than that registered in the preceding three-month interval, but it was still a considerable improvement over the experience of the past several years. However, the recent performance of the implicit price deflator understates to some extent the ongoing pace of inflation. During both the second and third quarters of this year, the composition of real output shifted toward goods whose prices have risen relatively slowly. While the GNP implicit deflator is constructed with current-quarter weights, the Department of Commerce also computes a fixed-weight price index for GNP based on the composition of real output in 1967. This fixed-weight price index rose at a higher 2.9 percent annual rate in the third quarter, though still slightly below the second-quarter pace and well under the increase of most recent years.

Consumer prices turned in a less encouraging performance in the third quarter. Indeed, in September, large increases in food and apparel prices combined to boost the total consumer price index at a 5.5 percent seasonally adjusted annual rate. Based on quarterly averages of monthly data, the consumer price index advanced at a 3.6 percent annual rate during the third quarter. This was higher than the rise in the preceding quarter or, indeed, in the year that ended with that quarter. A spurt in food prices accounted for much, though not all, of the acceleration.

Large increases in agricultural prices similarly pushed up wholesale prices at a faster rate in the third quarter than in the preceding three-month period. At the same time, however, the rate of rise in wholesale industrial prices eased somewhat. Based on quarterly averages, these prices rose at a 3.8 percent annual rate in the quarter, down almost 1 percentage point from the previous quarter's advance. For the most part, this slowdown was centered in prices of producers' durable equipment and of intermediate materials, excluding foodstuffs. This easing became even more pronounced in October when seasonally adjusted wholesale industrial prices were reported

to have fallen at a 1.1 percent annual rate. A smaller than usual rise in new automobile prices along with a downward price adjustment for quality improvements in the new models accounted for the decline in the seasonally adjusted index of wholesale industrial prices. However, even excluding the prices of passenger cars, wholesale industrial prices still remained virtually unchanged in October. At the same time, there was only a small advance in wholesale agricultural prices on a seasonally adjusted basis, following several months of rapid increases.



WAGES AND PRODUCTIVITY

The rate of growth of wages was also relatively moderate in the third quarter. Within the private nonfarm sector of the economy, employee compensation per hour of work rose at a 5.9 percent seasonally adjusted annual rate in the July-September period. This advance was about equal to the average of the preceding three quarters and well below the growth rates experienced in recent years. Similarly, the mean first-year increase in wages and fringe benefits provided by new major contract settlements negotiated over the first nine months of the year, though still high at 8.5 percent, was considerably below the 13 percent mean rises recorded in 1970 and 1971.

Productivity in the private nonfarm sector turned in a strong performance in the third quarter, as seasonally adjusted output per hour of work rose at a 6.3 percent annual rate. This measure of productivity has been on a generally upward path since the beginning of 1970 (see Chart III). Over the last four quarters, output per hour of work has increased 5.3 percent. The third-quarter advance in productivity again outpaced the rise in compensation per hour of work, so that, for the second consecutive quarter, labor costs per unit of output in the private nonfarm sector registered a slight decline.

The pace of wage increases appears to have accelerated in the past two months. According to upward revised figures for September and preliminary data for October, average hourly earnings of nonsupervisory personnel in the private nonfarm sector, adjusted for overtime hours in manufacturing and for interindustry shifts in employment, rose at an 8.2 percent seasonally adjusted annual rate in these months. In contrast, the growth in these earnings had been an unexpectedly slow 3.5 percent annual rate between April and August of this year. While the September-October acceleration was widely distributed throughout the private nonfarm sector, the wage hikes of workers in both the services and the finance, insurance, and real estate categories were especially big, exceeding 10 percent. However, even with this latest surge, the pace of wage increases has shown considerable moderation since wage controls were instituted. Thus, during the fourteen months since August 1971, average hourly earnings grew at a 6.2 percent annual rate, down almost a percentage point from the rate of growth experienced over the first eight months of 1971.

EMPLOYMENT

Further gains in employment were recorded in October. The poll of households conducted by the Bureau of Labor Statistics indicated that an additional 260,000 workers found employment in that month. While this was somewhat greater than the growth averaged in earlier months of the year, it was almost matched by an increase in the civilian labor force. As a result, the seasonally adjusted unemployment rate was unchanged in October at 5.5 percent. In its separate survey of employers, the Bureau of Labor Statistics found that employment in the private nonfarm sector expanded at a 5.3 percent annual rate in October, well above the 3.5 percent increase averaged over the first nine months of the year. In large part, this acceleration reflected the unusually rapid rise in manufacturing employment. At the same time, no change was reported in the workweek in either the manufacturing sector or the private nonfarm economy.

The Business Situation

The latest readings of the business situation point to a continuing rapid expansion in economic activity.[1] Consumers remain in the vanguard, as retail sales have posted exceptionally strong advances in recent months while purchases of new one-family homes have climbed to record levels. At the same time, there have been sizable increases in industrial production, in new orders for nondefense durable goods, and in inventory investment by manufacturers. Moreover, backlogs of unfilled durable goods orders and of unspent capital appropriations have risen, strengthening the basis for continued expansion of the economy. In conjunction with these developments, there has been additional improvement in labor market conditions, as evidenced by the further gains in payroll employment and by the fall in the unemployment rate to 5.2 percent in November.

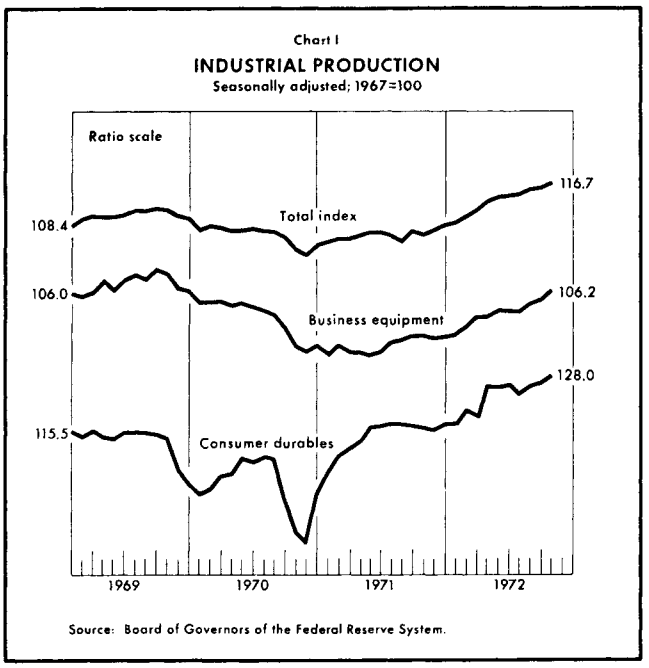
On balance, recent wage and price data suggest little change in the ongoing pace of inflation. The data continue to exhibit considerable month-to-month fluctuations. For example, average hourly earnings rose only modestly in November following two months of large increases. Wholesale industrial prices, on the other hand, posted a sizable increase in November after declining slightly in the previous month. Consumer prices as a whole rose in October at a rate slightly faster than the average monthly increase experienced during the earlier months of the year.

[1] The Department of Commerce has revised its estimate of growth in real gross national product (GNP) in the third quarter from a seasonally adjusted annual rate of 5.9 percent to 6.4 percent. The estimate of the increase in the fixed-weight price deflator for GNP was revised upward 0.2 percentage point to 3.1 percent per annum. Measured in terms of current dollars, there was a large upward revision in inventory investment which more than offset the modest reduction in the estimated rise in final expenditures. Profits before taxes advanced $4.2 billion in the third quarter to $95.8 billion at a seasonally adjusted annual rate.

PRODUCTION, ORDERS, APPROPRIATIONS, AND INVENTORIES

The Federal Reserve Board's index of industrial production rose at a very rapid 10.4 percent seasonally adjusted annual rate in October, bringing the annual growth rate to 9.5 percent for the first ten months of the year. The October advance was broadly based, with particularly strong gains in the output of business equipment and consumer durable goods (see Chart I). The increase in production of business equipment over the three months ended in October came to a 16.1 percent annual rate, more than double the rate of growth experienced in the earlier months of the year. All of the October expansion in consumer durable goods output was attributable to a large increase in the production of automotive goods. Domestic car production rose further in November to an annual rate of 9.8 million units on a seasonally adjusted basis, up about 8 percent from the October rate to one of the highest rates of output on record.

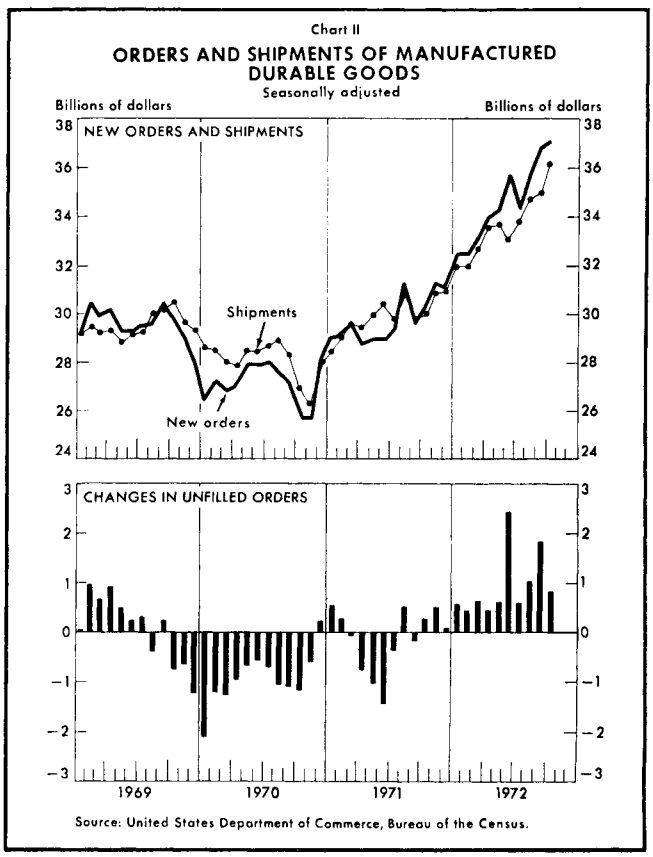
The seasonally adjusted flow of new orders received by durable goods manufacturers inched up by almost $200 million in October after having spurted in the previous two months. This data series is often quite volatile on a month-to-month basis, and recent movements have largely reflected unusually sharp fluctuations in new bookings for defense goods. A better indicator of the underlying orders situation is obtained by excluding defense bookings from the total. New orders for nondefense goods swelled 2.1 percent in October, slightly above the rate of growth experienced earlier in the year. Large increases in new bookings for nondefense capital goods and for automotive equipment swamped slight declines in orders for primary and fabricated metals. New orders for business equipment, in particular, posted a sizable 3.4 percent advance in October. Apart from a brief lapse during the June-August period, new orders for nondefense capital goods have strengthened considerably throughout the year, corroborating the results of the surveys of intended plant and

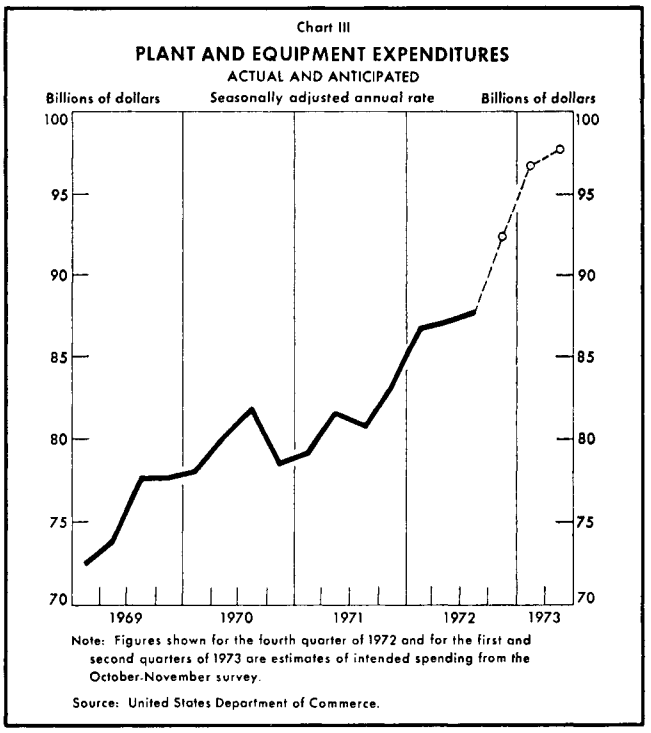


equipment spending taken earlier in the year. Since new bookings for durable goods again exceeded shipments in October, the backlog of unfilled orders increased for the thirteenth consecutive month (see Chart II). Since the beginning of the year, the stock of unfilled orders has grown at a 16.1 percent seasonally adjusted annual rate, after having declined somewhat in 1971. This growth in unfilled orders portends a continuing expansion in durable goods production in coming months.

According to the results of the Commerce Department's latest survey, businesses increased their expenditures on plant and equipment modestly in the third quarter, raising them by slightly more than $0.5 billion to a seasonally adjusted annual rate of $87.7 billion (see Chart III). Businesses also reported that they were planning to boost these expenditures by about $10 billion over the next three quarters. Actual spending on these capital goods during the first three quarters of this year thus ran 8.2 percent above the average for the comparable period of 1971. This rate of growth is a bit more than 2 percentage points below the intended increase in these expenditures that was reported in the Commerce Department's earlier survey taken in January and February of this year. The shortfall between actual and intended spending has been centered wholly in the manufacturing sector, but improvements in that area may well be in prospect. For example, in a separate survey of the nation's 1,000 largest manufacturers conducted by the Conference Board, these companies reported that their net new capital appropriations over the first three quarters of this year were 21 percent higher than those made in the same period of 1971. At the same time, these companies also reported that their actual capital expenditures were down slightly from last year's pace. Because all of this year's expansion in net new appropriations has been added to the backlog of unspent funds, it is likely that plant and equipment spending in the manufacturing sector will pick up in coming quarters.

Manufacturers have appreciably stepped up their spending on inventories since the middle of the year. In October, the book value of their inventories swelled by nearly $0.6 billion on a seasonally adjusted basis. The October increase was roughly in line with the large $1.9 billion advance posted during the third quarter and was well above the average monthly gain experienced over the first half of the year. Recent developments suggest that the long-anticipated acceleration in manufacturers' inventory investment may now be in progress. Between June and October, the increases in manufacturers' inventories have





been fairly widely distributed among inventories at different stages of fabrication. Particularly notable has been the buildup in the stocks of materials and supplies, inasmuch as these inventories had actually been run down slightly over the first half of the year. In addition, results from the Commerce Department's quarterly expectations survey suggest that further inventory accumulation is in prospect. The proportion of manufacturers evaluating their stocks as relatively low has jumped sharply, while there are correspondingly fewer manufacturers reporting relatively high stocks.

PERSONAL INCOME, RETAIL SALES, AND RESIDENTIAL HOUSING

Personal income advanced by an unusually large $15.2 billion in October, rising to a seasonally adjusted annual rate of $962 billion. The 20 percent increase in social security benefits that became effective at the beginning of the month contributed nearly $8 billion to the overall advance. At the same time, the increase in wage and salary disbursements to workers in the private economy was slightly more than $1 billion higher than the average increment registered in earlier months of the year. This larger than average rise reflected the healthy gains in both employment and average hourly earnings in the private sector.

Consumption spending was also quite buoyant in October. Seasonally adjusted retail sales spurted $1.3 billion, more than recouping the decline that had occurred in the preceding month. Preliminary data indicate that retail sales in November held at about the October level. Over the first eleven months of the year, the annual rate of growth of retail sales was an estimated 12.9 percent, up from the substantial 9.9 percent rise recorded last year. The rapid expansion in total retail sales during the year has been broadly based among both durable and nondurable goods.

Activity in the residential housing market maintained its vigorous pace in October. Private housing starts rose slightly in that month to a seasonally adjusted annual rate of 2.4 million units, about equal to the average of earlier months in the year but considerably higher than the level averaged last year. The October advance was concentrated in multifamily units, which climbed to their highest level in eight months. Starts of single-family units fell slightly in October, as they had in the preceding month. At the same time, sales of new one-family homes have picked up somewhat in recent months. These sales rose to a record annual rate of 786,000 units in August and held there in September as well. As a result, builders' inventories of unsold new homes leveled off in September, following nineteen consecutive months of growth.

EMPLOYMENT AND WAGES

Conditions in the labor market apparently improved further in November. According to the survey of households conducted by the Department of Labor, overall employment rose only modestly in November but the civilian labor force declined substantially on a seasonally adjusted basis. Consequently, the rate of unemployment dropped to 5.2 percent in November, after having averaged 5.5 percent over the previous five months. While the drop in the unemployment rate to the lowest level since August 1970 was an encouraging development, it must be interpreted with caution. Curiously, the decline in the labor force was primarily among heads of households. The sharp decline recorded in this group's rate of participation in the labor force is an unusual development during an economic upswing and may reflect statistical problems. In any event, because these people are the primary source of income for their families, it is unlikely that they will remain outside the labor force for any extended period of time.

A less ambiguous indication of the strengthening of the labor market is provided by the separate survey of estab-

lishments, also conducted by the Department of Labor. According to the latest monthly poll, firms added more than 200,000 workers to their payrolls in November. The increase, which was about equal to the average gain recorded in earlier months of the year, was broadly based, with especially large gains in employment in the trade and manufacturing sectors.

The average hourly earnings of workers in the private nonfarm economy, adjusted for overtime in manufacturing and for shifts in the composition of employment among industries, rose at an annual rate of only 1.7 percent in November, down considerably from the 9 percent average increase of the two previous months. Throughout the year, this measure of hourly wages has fluctuated widely, varying from a rise of 10.6 percent at an annual rate in April to no change in May. In any given month the rate of change in average earnings is the result not only of the average size of wage increases but also of the number of workers who receive raises, which varies considerably over the year. While seasonal adjustment is intended to smooth out the differing proportions in each month, it may well be that the pattern of wage increases during the current year has been atypical. One reason could be the requirement of Pay Board approval before many wage increases are permitted to become effective. Consequently, it may be better to examine the growth in wage rates over periods of several months. The annual rate of growth in the adjusted average hourly earnings was 5.9 percent during the period of the Economic Stabilization Program from August 1971 through November 1972. By comparison, this measure of earnings had increased at a 7.1 percent annual rate over the first eight months of 1971.

PRICES

Consumer prices advanced at a seasonally adjusted 3.8 percent annual rate in October, down almost 2 percentage points from the spurt of the previous month. Marked decelerations in the increases in prices of both food and nonfood commodities underlay the October slowdown. However, the October performance of consumer prices may understate the ongoing pace of inflation. The deceleration in prices of nonfood commodities was in large part the result of the smaller than usual rise in new car prices, reflecting the postponement of some intended price increases pending the Price Commission's approval. (Increases approved by the Price Commission on December 1 to cover the cost of safety and pollution-control equipment installed by the two major manufacturers will not be reflected in the consumer price index until December or later.) The advance in prices of services accelerated in October. It should be noted, however, that part of this increase reflected an annual adjustment in the index for health insurance rates.

Wholesale prices turned in a rather disappointing performance in November. Large increases in the prices of both agricultural and industrial commodities combined to raise the overall wholesale price index at a 7.4 percent annual rate in that month. Agricultural prices spurted at an 18 percent annual rate, reversing the moderation in the rate of growth in the preceding month. At the same time, prices of industrial commodities registered a sharp 5.5 percent annual rate increase. This was the largest rise since August 1971, just prior to the imposition of the three-month wage-price freeze. However, inasmuch as these prices are often given to erratic month-to-month movements, it may be better to view the November advance from a somewhat longer perspective. Thus, the annual rate of growth in the prices of industrial commodities was 2.2 percent over the three months ended in November and 3.7 percent in the year ended in November. In each case, this represents considerable improvement over the rate of inflation prevailing for several months prior to the wage-price freeze.

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The Business Situation

The vigorous expansion of economic activity appears to have gained further momentum. Industrial production has shown unusual strength over the past few months, spurred on by increased new orders for both durable and nondurable goods. Inventory spending has also been accelerating. Retail sales have remained very robust, with automobile sales proceeding at a particularly rapid clip, and residential construction has continued to show undiminished strength.

Labor market developments also testify to the vigor of the economy. In December the civilian labor force and employment both advanced strongly, and the unemployment rate stood at 5.2 percent, the same as in November but down from 6 percent a year earlier. Recent price and wage movements are mixed, however. Overall consumer prices rose moderately in November, but food prices increased considerably. Average hourly earnings posted only a small rise that month but then jumped sharply in December. Indeed, over the final quarter of the year, wages rose more rapidly than in the two preceding quarters.

INDUSTRIAL PRODUCTION, ORDERS, AND INVENTORIES

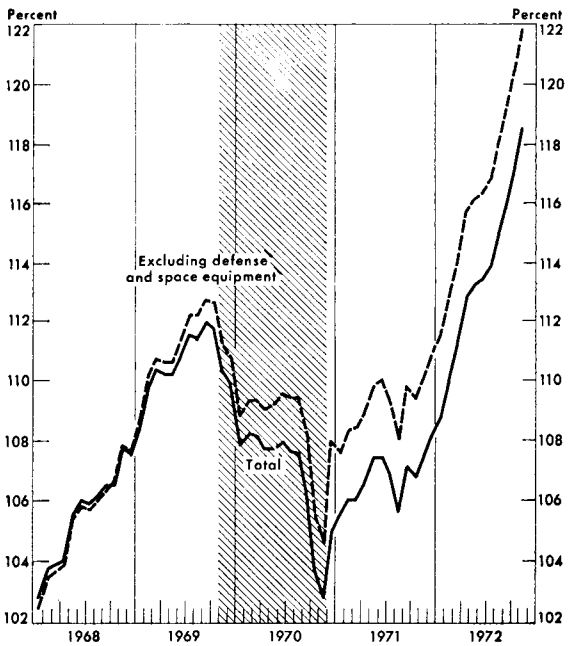
During November, the physical output of the nation's factories, mines, and utilities—as measured by the Federal Reserve Board's index of industrial production—climbed at an extremely rapid 13.3 percent seasonally adjusted annual rate. This constituted the fourth consecutive month of output growth at an annual rate in excess of 10 percent. Such sustained expansion has not been matched since the four-month period from December 1965 through March 1966. Over the first eleven months of the year, industrial production rose at an annual rate of 10.5 percent to a level more than 15 percent above the cyclical trough reached two years earlier (see Chart I).

The unusually rapid pace of expansion in November was widespread among production of final goods and materials other than the defense and space equipment category. Consumer goods production increased at a 14.4 percent annual rate, as the output of automobiles and parts, many types of appliances and furniture, and nondurable consumer goods increased rapidly. In November domestic car production rose to 9.7 million units at an annual rate, and in December to over 10 million units. Output in January is expected to run close to the November level. Since December 1971, production of consumer goods advanced at an 8.2 percent annual rate. Even this sizable gain is overshadowed by the exceptionally large increase in the production of business equipment, particularly since midyear. Business equipment output has advanced at an

Chart I

INDUSTRIAL PRODUCTION

Seasonally adjusted; 1967=100



Note: The National Bureau of Economic Research has tentatively placed the peak and trough points of the recession at November 1969 and November 1970, respectively. Data for latest four months are subject to revision.

Source: Board of Governors of the Federal Reserve System.

annual rate of 12.7 percent over the past eleven months and is now within 1 percent of the peak reached in September 1969.

New orders for durable manufactured goods rose sharply by more than $1 billion, or 3.1 percent, in November. The gain was widely distributed among bookings for primary metals, machinery, household durables, and capital goods. Orders for defense goods, which often fluctuate widely on a month-to-month basis, climbed by about $250 million in November, accounting for less than one fourth of the overall rise in bookings. The backlog of unfilled orders continued to rise during the month, increasing by slightly over $1 billion seasonally adjusted. This marked the fourteenth successive month in which the level of unfilled orders has advanced.

The accumulation of business inventories has gained momentum in recent months. In October, total business inventories rose nearly $1.2 billion. This increase came on the heels of the even more substantial August and September advances which averaged about $1.4 billion. By comparison, over the first seven months of 1972, inventory accumulation proceeded on average at less than $0.6 billion per month. Recent surveys indicate that this inventory buildup is expected to continue.

Preliminary manufacturing data for November suggest that inventory accumulation in this sector has continued at a healthy pace. Manufacturing inventories rose by $0.5 billion, seasonally adjusted, in November, which was about equal to the gain of the preceding month. The $0.6 billion monthly rise in manufacturing inventories averaged over the past six months is in line with increases posted in other expansionary periods. The advance of manufacturers' shipments surpassed inventory accumulation again in November, so that the ratio of inventories to sales continued to decline, reaching its lowest level since the beginning of 1966.

RESIDENTIAL CONSTRUCTION AND RETAIL SALES

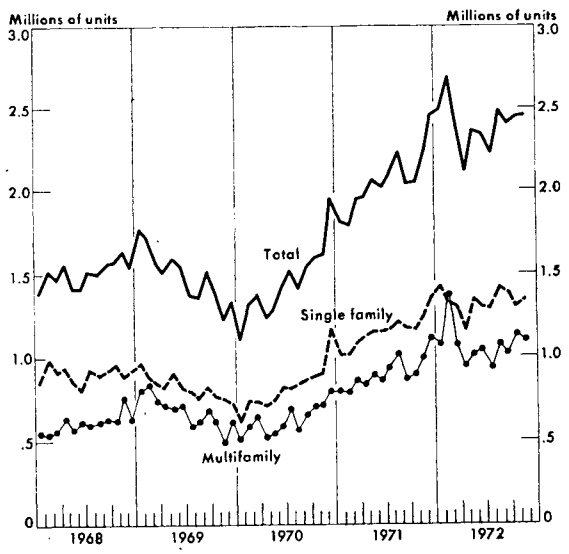
Residential construction is continuing at an extremely rapid pace. In November, private housing starts held steady at a substantial 2.4 million unit seasonally adjusted annual rate. Strength was evident in starts of both single- and multifamily dwellings (see Chart II). Although the multifamily total slipped somewhat from the October pace, it still was at one of the highest levels of the year. Single-family housing starts, on the other hand, rose from the previous month to a level slightly above the average of the first ten months of 1972. Sales of new one-family homes in October, the most recent month for which data are available, were at a seasonally adjusted annual rate of 853,000 units, easily surpassing the old record set in August. At the same time, builders' inventories of unsold new homes increased slightly to a record 394,000 at the end of October. These relatively high inventories and the 2½ percent November decline in newly issued building permits perhaps suggest a future reduction in starts to a rate more in line with estimates of long-run housing requirements.

Consumer spending has been extremely strong in recent months. According to preliminary data, retail sales in November held most of the exceptionally ample October gain. During these two months, retail sales averaged 3.6 percent above the monthly average of the third quarter. November sales of durable goods edged past the high October level, with automotive sales increasing and sales of other durable goods holding constant. The recent strength of the auto market is reflected in sales of domestically produced cars for November and December at seasonally adjusted annual rates approaching 10 million units. Moreover, unit sales of imported automobiles increased sharply in December for the second month in a row. Another indication of the exuberance of consumer demand is the rapid growth of consumer credit. The average monthly increase in consumer debt outstanding in 1972 through November, at $1.5 billion, was considerably greater than that of 1971 and nearly triple the low 1970 average.

Chart II

PRIVATE HOUSING STARTS

Seasonally adjusted annual rates



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

PERSONAL INCOME

Personal income expanded by a large $8.7 billion in November to a seasonally adjusted annual rate of $972.5 billion. This increase was considerably smaller than the $17 billion surge reported for the previous month, but the October gain included a 20 percent rise in social security benefits. Excluding this nonrecurring factor, the October and November increases were approximately equal. It should be noted that month-to-month fluctuations in personal income have been particularly large this year because of an exceptional number of unusual influences—the Federal civilian and military pay raise, the retroactive wage increases following the wage-price freeze, the increase in the social security tax base, the capital losses inflicted by tropical storm Agnes, and as noted above the social security benefits increase. In any event, over the first eleven months of 1972, personal income rose at an annual rate of 10.1 percent, with the wage and salary component advancing at a slightly slower pace.

EMPLOYMENT AND UNEMPLOYMENT

The labor market continued to show signs of strength in December. According to the survey of households conducted by the Department of Labor, civilian employment rose by 280,000 workers on a seasonally adjusted basis in December. Since the civilian labor force grew by a comparable magnitude, the overall rate of unemployment remained unchanged at November's level of 5.2 percent (see Chart III). Before November the unemployment rate had been stuck around 5.5 percent for five months. With the December figure, the total unemployment rate averaged 5.6 percent in 1972, down from the sticky 6 percent rate prevailing in 1971. Similarly, the unemployment rate for persons twenty-five years of age and older declined gradually in 1972, particularly over the last six months, so that the year's average of 3.6 percent was below the 4 percent rate posted in 1971. Fluctuations in unemployment rates for adults seem to be more meaningful indicators of labor market conditions than do changes in rates of younger workers, since the latter tend to be more volatile as a result of high turnover rates and resultant periodic employment. Married men constitute another significant labor subgroup because of their exceptionally strong attachment to the labor force. The unemployment rate of married men declined considerably over the year, averaging 2.8 percent in 1972 compared with the 3.2 percent level of the preceding year. By the fourth quarter of 1972, the rate of unemployment for married men was down to an average of 2.5 percent. In the past, such low levels of unemployment among these primary workers have tended to be accompanied by upward pressures on prices.

Although nonagricultural payroll employment increased only marginally in December, payroll data over the final quarter of 1972 show a healthy 716,000 worker increase —more than one fourth the substantial gain registered in 1972. The overall improvement in the labor market last year is clearly evident as the increase in payroll employment of over 2.6 million workers was more than two and a half times the expansion in 1971. Manufacturing payrolls, which actually declined in 1971, climbed by 4½ percent in 1972, and this was accompanied by a marked rise in both the average factory workweek and hours of overtime. In fact, in December, weekly hours in manufacturing reached their highest level since mid-1968 and overtime was at its highest since late 1966.

WAGES AND PRICES

There have been some indications in recent months that the pace of the advance in wages is again beginning to quicken, although the month-to-month variation in wage growth has been quite wide. Average hourly earnings of production and nonsupervisory workers in the private nonfarm economy, adjusted for overtime hours in manufactur-

ing and for shifts in the composition of employment among industries, increased in December at a rapid 10.7 percent seasonally adjusted annual rate after advancing at only a 1.7 percent pace in the previous month. On average over the fourth quarter, the growth in hourly earnings accelerated to a 7.4 percent annual rate from the preceding three-month period, up from the more moderate second- and third-quarter gains of 5.4 percent and 5.1 percent, respectively. Although on balance the 5.9 percent annual rate of advance in wages since January 1972 is still slower than the 7.2 percent increase experienced in 1971 before the freeze, increases in the final months of last year suggest that movements in wages will bear watching closely in 1973, with its heavy schedule of collective bargaining agreements to be negotiated.

Consumer prices rose at a 3.3 percent seasonally adjusted annual rate in November, the slowest advance in three months. Food prices surged ahead at a 14 percent annual rate, but prices of consumer nonfood commodities and services rose only moderately. Over the three months ended in November, prices of consumer nonfood commodities increased at less than a 2 percent annual rate and in the year since November 1971—the period covered by Phase Two of the Economic Stabilization Program—such prices rose about 2½ percent. Of course, the recent slowdown was strongly influenced by delay in Price Commission approval of some price increases for new 1973 model cars. Nevertheless, over the past year, nonfood commodity price increases represent considerable improvement relative to the rapid advances experienced in 1969 and 1970. Similarly, prices of services have risen 3½ percent over the past year, well under the pace of 1969, 1970, and the first eight months of 1971.

PERSPECTIVE 72

Each January this Bank publishes *Perspective,* a nontechnical review of the major domestic and international economic developments of the previous year. A more comprehensive treatment is presented in our *Annual Report,* available in March.

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The Business Situation

The latest business indicators provide further confirmation that the domestic economy has expanded vigorously in virtually every sector in recent months. Real gross national product (GNP) surged ahead at a very rapid 8.5 percent annual rate in the fourth quarter, with both consumption and investment spending increasing sizably. Moreover, a recent Department of Commerce survey indicates a further acceleration in business investment in 1973. Industrial production increased strongly in December on the heels of even larger earlier gains. In view of the high rate of new orders for durable manufactured goods and the persistent rise in unfilled orders, further strong advances in output appear likely in the coming months. The unemployment rate declined in January to 5 percent, its lowest point in two and a half years, and further improvement appears likely.

The outlook for prices, on the other hand, is clouded by several factors. The effectiveness of the largely voluntary controls under Phase Three of the Economic Stabilization Program is yet to be tested. Consumer prices advanced only modestly in December, but prices of farm products and processed foods and feeds exploded at the wholesale level and it is likely that these increases will ultimately be passed on to the consumer. The fixed-weight price deflator for total GNP rose at a 3.4 percent annual rate in the fourth quarter. While still moderate, this was a more rapid rise than that experienced over the preceding six months. Recent compensation data suggest that there has been some acceleration in wage increases as well which, together with the large increase in social security taxes effective this year, could exert upward pressure on prices in coming months.

GROSS NATIONAL PRODUCT AND RELATED DEVELOPMENTS

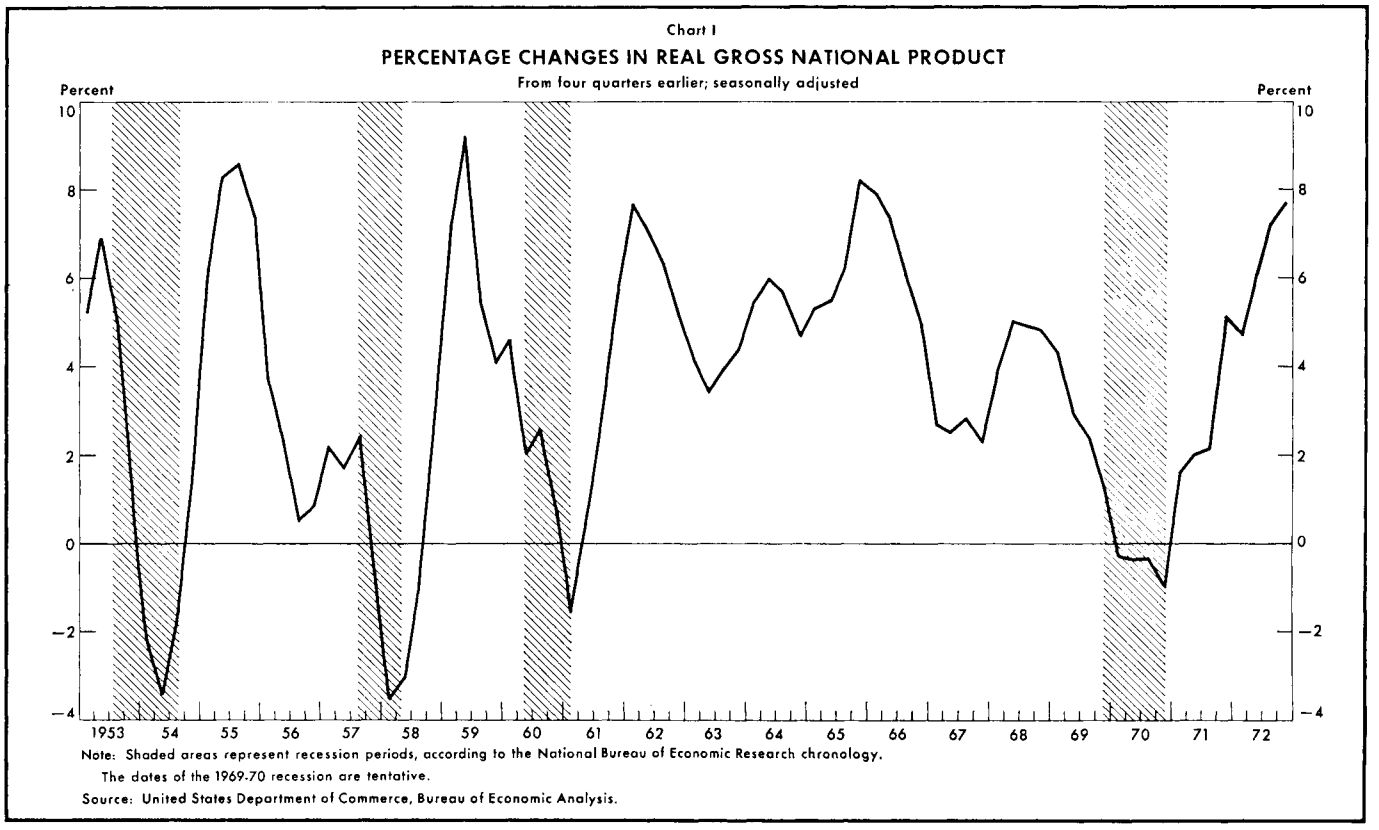
According to preliminary estimates from the Department of Commerce, the market value of the nation's output of goods and services rose $31.8 billion to a seasonally adjusted annual rate of $1,195.8 billion in the fourth quarter of 1972. After adjustment for changes in the price level, real GNP expanded at a sharp 8.5 percent annual rate. Since the last quarter of 1971, real output advanced at an extremely rapid 7.7 percent rate, the fastest four-quarter increase in more than six years (see Chart I).

Tentative and incomplete data indicate that the advance in the rate of inventory spending contributed $2 billion to the growth of GNP in the fourth quarter (see Chart II), as inventory accumulation reached a $10 billion annual rate, its highest in five years. Notwithstanding this marked pickup in inventory spending, the ratio of inventories to sales for all business continued to fall in November, the latest month for which data are available, suggesting that further strengthening in this area may be in the offing.

The fourth-quarter rise in current-dollar final expenditures—GNP net of inventory accumulation—amounted to a substantial $29.8 billion, an annual rate of increase of over 10 percent. Among the components of final expenditures, consumer purchases and business fixed investment spending were particularly robust. State and local government purchases of goods and services also contributed strongly to boosting final demand.

Personal consumption expenditures rose by a substantial $17.6 billion during the fourth quarter. The more than 9.5 percent growth of consumption over the year had not been matched since 1968. Outlays for nondurable goods and services posted strong gains in the final quarter, while the gain in durable goods spending moderated somewhat as the increase in unit sales of domestic and imported automobiles was less ebullient than during the July-September period.

The vigorous fourth-quarter expansion in consumer spending was accompanied by an unusually large $34.4 billion increase in personal income. However, the fourth-quarter jump stemmed in part from several nonrecurring factors, including the 20 percent increase in social security benefits which became effective in October and the substantial addition to railroad retirement and veterans' educational benefits in November. But, even if all trans-



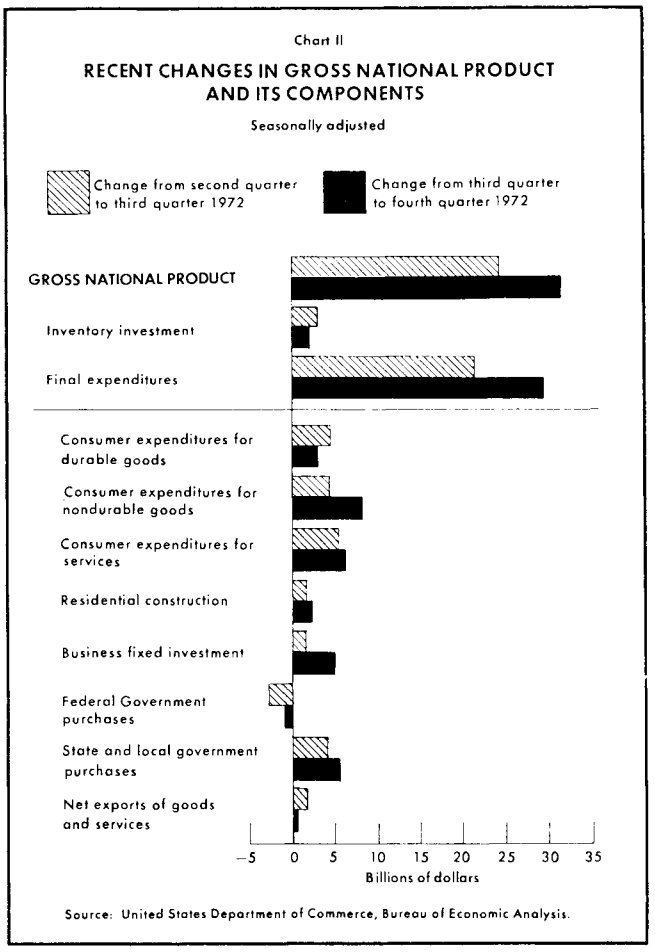
fer payments are excluded from the third- and fourth-quarter totals for 1972, personal income still grew by a rapid $23.6 billion in the final quarter. Increases in wage and salary payments remained the cornerstone of this advance as a result of further gains in employment, earnings, and hours. Farm income also expanded rapidly in the last two months of 1972. The rate of savings out of disposable income jumped from 6.4 percent in the third quarter to 7.5 percent, thus reversing the generally lower trend shown by the savings rate earlier this year. Probably the fourth-quarter rise reflected the unusually large size of the increase in disposable income, since consumers generally seem to require some time to adjust consumption patterns to sudden advances in income. Nevertheless, because of the substantial tax refunds expected in the first half of 1973 as a result of the overwithholding of personal income taxes last year, the savings rate may well remain close to this level or climb somewhat further in the quarters immediately ahead.

Business fixed investment grew by $4.9 billion in the fourth quarter, with the gain divided between expenditures for producers' durable equipment and structures. Over 1972, such investment spending expanded at nearly a 14½ percent rate, compared with the 11½ percent increase recorded in 1971. Rising new orders for nondefense capital goods equipment point to continued strength in investment. In addition, the Federal Reserve Board's index of capacity utilization for the fourth quarter of 1972 reached its highest mark since early 1970. The latest Commerce Department survey indicates that intended outlays for plant and equipment (which does not include certain types of fixed investment such as trucks and buses) are expected to rise in 1973 by almost 13 percent, somewhat more than had been indicated by earlier surveys and substantially above the 9 percent increase posted for 1972. In particular, the Commerce survey suggests a 13½ percent rise in capital outlays in manufacturing industries and a 12½ percent advance in other sectors.

Residential construction expenditures increased by $2.4 billion in the October-December period, capping a strong year for home building. On a seasonally adjusted basis, home-building outlays were 20 percent greater in the

fourth quarter than they had been a year earlier and were almost double their recession low of the second quarter of 1970. Underpinning this persistent strength, the pace of housing starts remained rapid during the last months of 1972. In addition, the number of newly issued building permits granted reached a record peak in December.

Expenditures of state and local governments climbed by a substantial $5.6 billion in the fourth quarter, primarily reflecting the stepped-up pace of their construction activity. With the enactment of revenue sharing and the favorable budget position of many states and localities, further sizable gains in spending may be in the offing. On the other hand, Federal purchases of goods and services declined by $0.9 billion in the fourth quarter, attributable to a $0.7 billion slowdown in defense spending following the even more substantial $3.5 billion third-quarter reduction.



PRICE DEVELOPMENTS

While inflationary pressures for most goods and services appeared to subside somewhat during Phase Two, the outlook for additional improvement on the price front is uncertain. The persistent and extraordinarily rapid run-up in prices of farm products and processed foods and feeds at the wholesale level is disturbing and should have an adverse impact on consumer food prices in early 1973. The liberalization of wage and price controls effected in Phase Three of the Economic Stabilization Program has added to the uncertainty. Adherence to the wage and price guidelines was made largely voluntary except in the food, health, and construction industries where controls remain mandatory. In addition, rent controls were abolished and the profit margin guidelines were liberalized somewhat. It is certainly too early to tell how this new strategy will affect prices in 1973, although some immediate bulge may materialize as some firms implement price increases that had previously been awaiting the approval of the Price Commission.

With the notable exception of food prices, the pace of inflation appears to have changed little in recent months. According to preliminary estimates, the implicit price deflator for total GNP advanced at a 2.7 percent annual rate in the fourth quarter, slightly above the 2.4 percent third-quarter increase. By the end of 1972, the GNP deflator had risen only 3 percent from four quarters earlier, its slowest pace in seven years. However, the implicit price deflator is affected by shifts in the composition of output toward either lower or higher priced goods. The fixed-weight deflator computed by the Department of Commerce corrects for this problem as it is based on the composition of real output in 1967. This fixed-weight price index showed an increase of over 3.9 percent during 1972. For the fourth quarter as well, the fixed-weight deflator rose more rapidly than the implicit GNP deflator.

Wholesale prices rose at a sharp 9.6 percent seasonally adjusted annual rate from September to December. This rapid increase was the result of an extraordinary rise in agricultural prices; by comparison, increases in wholesale industrial commodity prices have been moderate, rising only 2 percent over the quarter. Prices of farm products and processed foods and feed increased sharply in November and soared in December, climbing by 5.2 percent seasonally adjusted in that month alone. Of course, this gain is likely to be reflected in months to come in consumer food prices. The December surge in wholesale food and feed prices stemmed from large increases in prices of grains, oil seeds, and manufactured animal feeds as well as continued increases in egg and livestock prices. Heavy do-

mestic and foreign demand underlies the strong upward movement in food and feed prices apparent since last spring. In particular, sales of wheat to the Soviet Union in 1972 accounted for about one fourth of the domestic wheat harvest. In addition, on the supply side, bad weather affected the harvesting of many crops in recent months. A number of steps have been taken to increase the supply of farm and food products. Among these are the elimination of meat import quotas and the increase in the allowable acreage for planting and grazing under Federal farm subsidy programs.

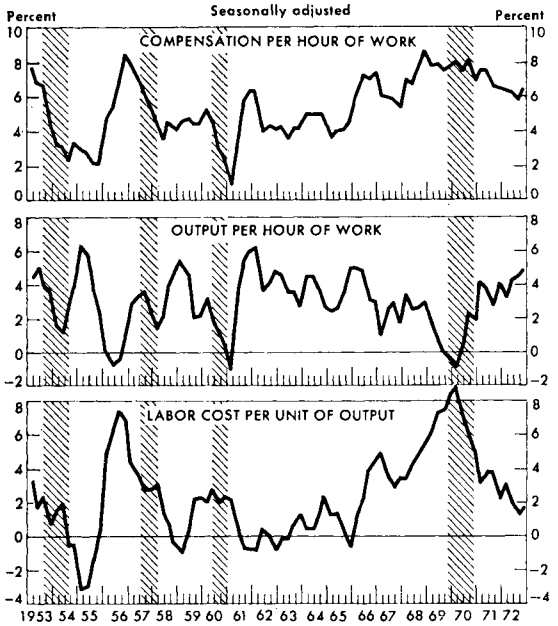
Consumer prices rose at an annual rate of only 2.6 percent in December, but prices of nonfood commodities and services showed gains somewhat above the monthly average for 1972. Over the last three months of 1972 consumer prices increased at an annual rate of 3.2 percent, bringing the increase for the year as a whole to 3.5 percent. During the fourth quarter, nonfood commodity prices increased at an annual rate of only 1 percent but food prices posted a rapid 5.2 percent rate of advance, largely because of a substantial jump in November. Somewhat surprisingly, seasonally adjusted food prices held steady in December, as declines in beef prices offset increases for eggs, cereals, and bakery products. At the same time, prices for services climbed at a 4.5 percent annual rate, a more rapid advance than that experienced overall in 1972.

Chart III

LABOR COMPENSATION, PRODUCTIVITY, AND UNIT LABOR COST IN THE PRIVATE ECONOMY

CHANGE FROM FOUR QUARTERS EARLIER

Seasonally adjusted



Note: Shaded areas represent recession periods, according to the National Bureau of Economic Research chronology.

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

WAGES, PRODUCTIVITY, AND EMPLOYMENT

During the fourth quarter, compensation per hour of work in the private economy increased at a 7.8 percent seasonally adjusted annual rate, compared with the 4.3 percent rate of increase posted in the previous three-month period. Despite this acceleration, a fundamental slowing in the rate of increase in compensation is apparent over the eight quarters since the cyclical trough at the end of 1970 (see Chart III). It is, however, uncertain that this improvement can be extended. Compensation per hour of work in the private nonfarm economy, which excludes the sometimes volatile farm sector, also posted a faster increase in the fourth quarter than in the third. Preliminary data indicate that average hourly earnings adjusted for interindustry shifts in employment and for overtime in manufacturing rose less rapidly in January than in the last quarter of 1972.

During the final three months of 1972, increases in wages and benefits under collective bargaining agreements covering 5,000 or more workers moderated further, thus continuing the improvement evident earlier in the year. For 1972 as a whole, first-year wage and fringe benefit increases averaged 8.4 percent, a significant slowing from the gain of around 13 percent for the preceding year. At the same time, however, contract duration decreased somewhat in 1972, as unions seemed reluctant to commit themselves to long-term settlements under Phase Two. Furthermore, new settlements covering some 900,000 workers were not included in the 1972 bargaining data since they had not received Pay Board approval at the end of the year. In any event, the collective bargaining schedule for 1973 is heavy, and further moderation in this area is essential if cost pressures are to be restrained.

Productivity, as measured by output per hour of work in the private economy, increased over the October-December interval at a 5.4 percent annual rate, up considerably from the pace of the previous quarter primarily because of a sharp improvement in the agricultural sector. Nevertheless, the 4.9 percent increase in productivity over the four quarters of 1972 was faster than in any year since 1965. As in previous periods of rapid economic expansion, the advance in unit labor costs has slowed considerably. Although fourth-quarter data indicate an expansion in unit labor costs at a 2.6 percent seasonally adjusted annual

rate, over 1972 as a whole such costs rose only 1.7 percent. In contrast, unit labor costs climbed at rates of between 3.5 percent and 8.3 percent during 1966 through 1970 and at a 2.2 percent pace in 1971.

According to the monthly survey of households, the civilian labor force and employment declined in January after adjustment for seasonal variation. Much of the decline in employment took place in the agricultural sector. At the same time, the unemployment rate dipped to 5 percent from the downward revised 5.1 percent rate now reported for December. This brought the rate of unemployment to its lowest level since July 1970. The household series was revised back to 1967 as part of the annual updating of seasonal adjustment factors. Unemployment rates for most major groupings in January were similar to those posted in December, although the rates for workers under twenty-five years of age showed sizable declines. The January survey of establishments indicated a continued rise in nonfarm payroll employment in that month, with gains widespread among industries. (Discrepancies in the movement of the household and payroll series occur because of different survey coverage and seasonal adjustment techniques.) Based on preliminary data, sizable declines were posted in the average workweek in the manufacturing sector and the private economy as a whole in January, and overtime in manufacturing also fell for the first time in seven months. However, these data may be subject to some revision when the total payroll sample becomes available.

Monetary and Financial Developments in the Fourth Quarter

During the fourth quarter of 1972, the narrowly defined money supply (M_1) increased more rapidly than it had during the preceding three months. Most of this increase was attributable to a sharp acceleration of M_1 in December following the more moderate expansion in October and November. Although M_1 advanced rapidly, a mild slowdown of the large inflows to savings and consumer-type time deposit accounts at commercial banks held the growth of the broad money supply (M_2) about even with the third-quarter rate. The bank credit proxy expanded at a somewhat faster rate than in the third quarter. Furthermore, burgeoning loan demand brought larger increases in total bank credit. Reflecting the high rates of growth of the monetary aggregates, reserves available to support private nonbank deposits (RPD) in the fourth quarter climbed at a seasonally adjusted annual rate of 10.5 percent, a little more quickly than in the third quarter. As was the case in the preceding three months, much of this reserve expansion resulted from a rising volume of member bank borrowings at the discount window.

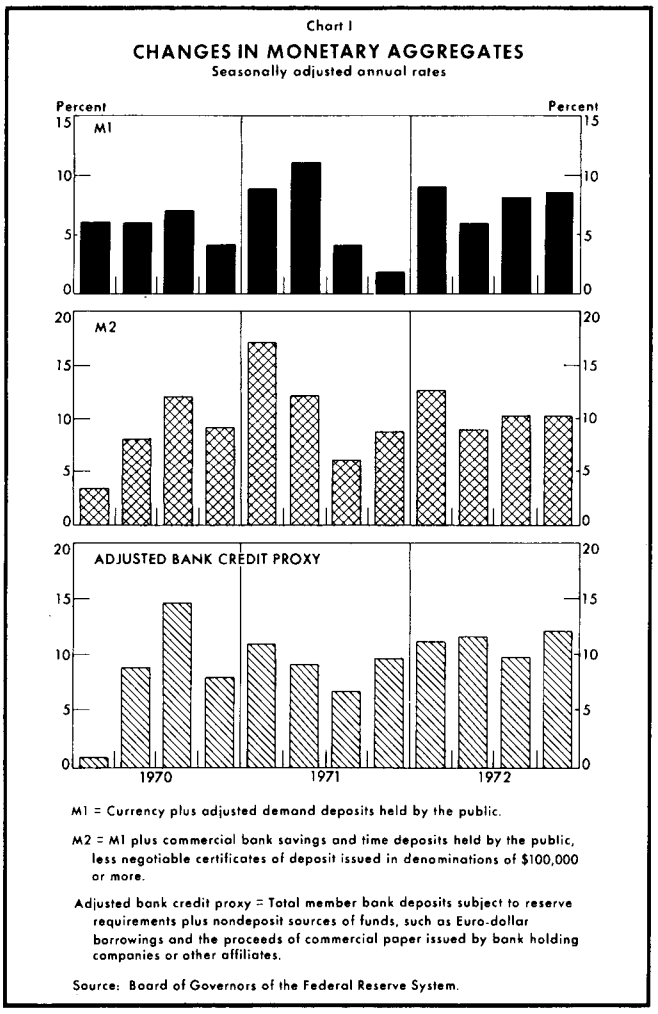
Interest rates at the short and long ends of the maturity spectrum moved in different directions during the final months of the year. Short-term rates rose briskly in response to the continuing business recovery and the rising demand for short-term funds in the economy. In contrast, long-term bond yields fell substantially in October and November, as the moderation of inflationary expectations was joined by a decline in the volume of new corporate flotations and easing credit demands by state and local governments. Long-term yields did rise in December, however.

This strength in the capital markets was further manifested in the continuing healthy performance of the nonbank depository institutions as suppliers of funds to the residential mortgage market. Although deposit inflows slowed from earlier 1972 levels, these inflows remained substantial and mortgage lending stayed at high levels. Mortgage yields rose somewhat in the final quarter of the year, but still were lower than those prevailing at the beginning of the year.

THE MONETARY AGGREGATES

The narrowly defined money supply (M_1)—private demand deposits adjusted plus currency outside commercial banks—increased in the final quarter of 1972 at a rapid seasonally adjusted annual rate of 8.6 percent, 0.4 percentage point faster than the expansion of M_1 during the preceding three-month interval (see Chart I). This brought the growth of M_1 for the entire year to 8.3 percent, the largest yearly increase in the post-World War II era. The rapidity of M_1 growth during the fourth quarter reflected a 13.3 percent spurt during December. In contrast, during October and November M_1 increased at more moderate rates averaging 6.2 percent.

The impact of the December spurt in M_1 on the growth rate for the fourth quarter was similar to that of the major role played in the third-quarter expansion of M_1 by the quick jump in the money supply during July. Both the size of M_1 increases in July and December and their impact upon the quarterly growth rates illustrate the difficulty of influencing the monetary aggregates in the short run. The M_1 surge in December reflected to some extent a sharp increase in demand deposits of state and local governments, some of which were slow in investing their part of the $2.7 billion in Federal revenue-sharing payments that were disbursed in December. Moreover, the general demand for money has doubtless been increasing as a result of the gathering momentum of the economic recovery.



The broad money supply (M_2)—which adds to M_1 savings deposits and time deposits other than large-denomination certificates of deposit (CDs) at commercial banks—advanced at a seasonally adjusted annual rate of 10.2 percent in the fourth quarter, about the same as in the previous quarter. This steady growth of M_2 reflected the effects of moderating flows in the time deposit component of M_2 which offset the acceleration in the narrow money supply. The growth of large CDs also slowed in the fourth quarter as a whole, although the investment of revenue-sharing funds by state and local governments contributed to the December climb in CDs at the extremely rapid annual rate of 58 percent. The adjusted bank credit proxy, which is a measure of total member bank deposits subject to reserve requirements plus liabilities to foreign branches and bank-related commercial paper, grew at a relatively steady pace throughout 1972. United States Treasury deposits and commercial paper issued by bank holding companies increased significantly in the October-December interval. On balance, the bank credit proxy advanced at a 12.1 percent seasonally adjusted annual rate during the fourth quarter, which brought the credit proxy to a level 11.6 percent above that at the end of 1971.

RPD expanded at a 10.5 percent annual rate in the fourth quarter, compared with 10 percent for the third quarter and for all of 1972 (see Chart II). As was the case in the third quarter, the principal source of RPD expansion was the rise in member bank borrowings from the Federal Reserve. On the basis of monthly averages of daily figures, borrowings rose from $514 million in September to $1,050 million in December. On the other hand, the nonborrowed component of RPD moved up only marginally at a 0.4 percent rate in the fourth quarter. Most member banks had not made frequent use of the discount window earlier in the year. The large increase in borrowings toward the end of the year reflected mounting pressure on bank reserve positions, occasional shortages of Federal funds in the market, and the rising cost of obtaining Federal funds in the market. The average Federal funds rate

The Business Situation

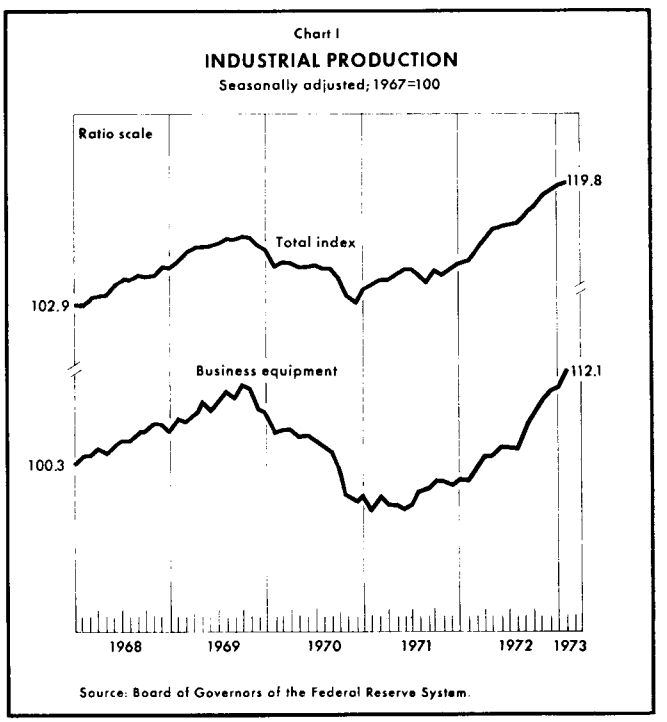
The latest readings on economic activity indicate continued substantial expansion in the domestic economy.[1] Consumer spending has remained in the forefront, as retail sales posted a strong advance in January. Seasonally adjusted purchases of new domestic-type automobiles continued strong in February. Housing starts climbed further in January after a very vigorous fourth quarter, and new orders for durable manufactured goods surged ahead. While overall industrial production rose moderately, output of business equipment increased sharply, surpassing the previous peak set in the fall of 1969. There is evidence of a more vigorous buildup of inventories and greater strength in the capital goods area.

The near-term outlook for prices, on the other hand, appears discouraging. Wholesale prices of agricultural products advanced at a very rapid rate in February, following a similar increase in January and marking the fourth consecutive month of inordinately large advances. These increases have begun to be reflected in consumer food prices; in January, such prices soared at a seasonally adjusted annual rate of 25 percent. Although consumer nonfood commodity prices were steady in January, wholesale industrial commodity prices shot up in February at the fastest rate in over twenty years. This increase seems likely to be reflected in higher prices at the consumer level in the months to come.

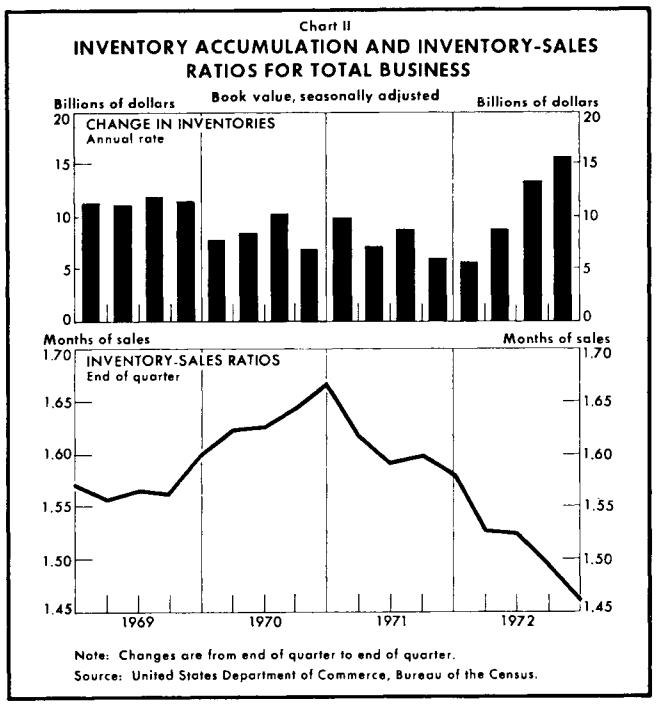
INDUSTRIAL PRODUCTION, ORDERS, AND INVENTORIES

The growth of industrial output apparently moderated somewhat in January after rising very strongly during 1972. The Federal Reserve Board's index of industrial production rose at a 6 percent seasonally adjusted annual rate in January by comparison with the 10.2 percent advance experienced over the preceding year. Output of business equipment climbed sharply in January to a level surpassing the previous peak of September 1969 (see Chart I), and output of consumer nondurable goods moved up as well. On the other hand, production of materials and intermediate products was virtually unchanged, while output of consumer durables and defense and space equipment declined. Domestic car production, at seasonally adjusted annual rates of 9.7 million units in January and 10.1 million in February, while below the unusually high December rate, was well above the 8.8 million units produced in all of 1972.

Preliminary data indicate that new orders for durable



[1] In its revised figures for fourth-quarter 1972 gross national product (GNP), the Department of Commerce reduced its estimate of current-dollar GNP from $1,195.8 billion to $1,194.9 billion. This downward revision stemmed primarily from smaller increases in consumption and government spending. Growth in real GNP in the fourth quarter was not so rapid as first estimated, although it was still a strong 8 percent. On the other hand, the estimate of the implicit price deflator for GNP was raised marginally.



manufactured goods rose in January by a huge $2.2 billion, or nearly 6 percent. Defense bookings increased considerably after declining in December. In addition, new orders for nondefense capital goods expanded by almost $0.5 billion, substantially more than the average increase over the previous six months. Bookings for primary metals and machinery also moved up in January. Shipments increased markedly as well but remained below the level of new orders. As a result, the backlog of unfilled orders climbed significantly for the sixteenth consecutive month.

Business inventory spending has continued at an accelerated pace in recent months. In December, the book value of manufacturing and trade inventories increased $16.1 billion at a seasonally adjusted annual rate, bringing the average monthly gain for the fourth quarter to $15.6 billion. This gain surpassed the third-quarter average of $13.3 billion and was well above the rate of inventory accumulation in the first two quarters of the year (see Chart II). During the fourth quarter, sales advanced more rapidly than inventories so that the ratio of inventories to sales declined to 1.46, down from 1.49 three months earlier. At the end of 1971 the inventory-sales ratio had stood at 1.58.

Over 1972 as a whole, business inventories climbed by $10.8 billion, almost $3 billion more than the 1971 increase and the largest yearly gain since 1969. Over half of the increase in stocks occurred in manufacturing inventories. In turn, much of this buildup was in durable goods industries and stemmed in part from the vigor of motor vehicle production during the year as well as from the rebound in the aircraft industry. Preliminary data for January indicate that manufacturing stocks edged up further at a $2.6 billion seasonally adjusted annual rate. The increase in durables manufacturers' inventories more than offset a slight decline in nondurables inventories.

RESIDENTIAL CONSTRUCTION, RETAIL SALES, AND PERSONAL INCOME

Residential construction activity is continuing at a very rapid rate. In January, private housing starts surged to a seasonally adjusted annual rate of 2.5 million units. Although the multifamily total fell somewhat from the unusually high December level, it was only slightly below the average for 1972. Single-family housing starts, on the other hand, rose to a new high in January, exceeding the previous record set in January 1972. It should be noted, however, that starts may have been artificially boosted in recent months as some builders may have accelerated activity prior to the freeze on Federal subsidy programs. Newly issued building permits fell 8.1 percent in January from the very high level of the previous month.

Sales of new one-family homes in December, the most recent month for which data are available, rose to a seasonally adjusted rate of 724,000 units. Builders' inventories of unsold new homes were at 404,000 at the end of December, leaving the ratio of unsold new homes to sales of new one-family homes only slightly below the very high November level. The vacancy rate on residential rental properties fell to 5.6 percent of available stocks in the fourth quarter, down from the third-quarter average of 5.8 percent. The average rate for the four quarters of 1972, however, was the highest annual rate since 1968. Vacancy rates on homeowner properties rose slightly in the fourth quarter of 1972, but were unchanged from the level of a year earlier.

Consumption spending was also strong in January, as seasonally adjusted retail sales rose $1.2 billion above the upward revised December level. The increase was broadly based in sales of both durable and nondurable goods. The continuing strength of the auto market was evident in January sales of new domestic-type automobiles, which reached a seasonally adjusted annual rate of 10.3 million units on the heels of fourth-quarter sales that averaged 9.9 million units at an annual rate. Moreover, the January sales pace was the most rapid rate since September 1971,

when domestic car sales were stimulated by the price freeze, the removal of the excise tax on automobiles, and the import surcharge. Auto sales continued high in February at a seasonally adjusted annual rate of 9.9 million units, including a record 2 million of imported cars. Demand for imported cars was undoubtedly stimulated by expectations of price increases for imports in the future stemming from the devaluation of the dollar.

Further sizable advances in retail sales appear possible in the months ahead. Substantial tax refunds are expected in the first half of the year as a result of the overwithholding of personal income taxes in 1972. Undoubtedly, some of these funds will be channeled into consumption. Furthermore, the latest surveys of consumer intentions indicate continued strength in expenditures. At the same time, however, the University of Michigan Survey Research Center reported a leveling-off of consumer optimism in the fourth quarter of 1972, albeit at a relatively high level. There is some evidence in the Michigan survey that consumers have become more concerned in recent months about rising prices of essentials.

Personal income rose only $2.5 billion in January to a seasonally adjusted annual rate of $985.4 billion. This was a small gain, compared with monthly increases in the fourth quarter of 1972 which averaged $12 billion. A number of factors, however, acted to inflate the fourth-

Fifty-eighth Annual Report

The Federal Reserve Bank of New York has published its fifty-eighth *Annual Report,* reviewing the major economic and financial developments of 1972.

The *Report* commented that monetary policy in 1972 sought to "encourage growth in the monetary aggregates rapid enough to sustain the expansion of real economic activity, and thus help to lower unemployment, but not so rapid as to undermine efforts to reduce the rate of inflation". It further noted that "the pursuit of this objective entailed strenuous efforts" early in the year "to stimulate the money supply's growth in the wake of a period of sluggishness in late 1971" but that "the immediate objective of System policy soon shifted to the attainment of moderate money supply growth". The appropriateness of this change in focus "was reinforced by the mounting evidence of the strengthening recovery in economic activity". Nevertheless, the *Report* said, growth in the monetary aggregates in 1972 was "somewhat more rapid than would seem desirable, if a noninflationary environment is to be achieved and maintained".

In his letter presenting the *Report* to the member banks, Alfred Hayes, President of the Bank, said that "the prospects for continued improvement in the economy seem good", but that the outlook is "clouded by a number of uncertainties". He observed also that, although "some steps have been taken to deal with these problems, . . . there is still much unfinished business. The realignment of international exchange rates must be supported by appropriate stabilization policies in the United States and by a sincere effort on the part of all nations to reduce the many remaining barriers that distort trading patterns. The Phase Three wage and price restraints will require vigorous surveillance as well as a voluntary cooperation". Moreover, he stressed, "it is imperative that monetary and fiscal policies become less stimulative than they were last year".

The *Annual Report* may be requested from the Public Information Department, Federal Reserve Bank of New York, 33 Liberty Street, New York, N.Y. 10045. A copy is being mailed to *Monthly Review* subscribers.

quarter increases in personal income, particularly a 20 percent rise in social security benefits in October. On the other hand, personal income in January was reduced $5.2 billion by an increase in social security contributions, although this was offset to some extent by a Federal civilian and military pay raise. In the absence of these special factors, the January increase would have been $5.8 billion, slightly lower than the revised December increase of $6.7 billion.

PRICE DEVELOPMENTS

The persistence of inflationary pressures is evident in the latest price statistics. Wholesale prices advanced at a very rapid 21 percent seasonally adjusted annual rate in February following increases of 13.5 percent in January and more than 21 percent in December. The primary source of the December and January increases was the surge in prices of farm products and processed foods and feeds, which climbed at a seasonally adjusted annual rate of about 60 percent over those two months. Such prices continued to rise sharply at a 46 percent seasonally adjusted rate in February. Moreover, wholesale prices of industrial commodities in February soared at a 12 percent seasonally adjusted annual rate, the highest monthly increase in over twenty years. The February increase compared with a 4 percent rate of rise in January and was much higher than the 2.6 percent rate of increase experienced over the second half of 1972. The February surge in wholesale industrial commodity prices was broadly based in the various industrial subsectors but with particularly large gains in prices of fuel and related products and in lumber prices. On March 6 the Cost of Living Council announced the imposition of mandatory price controls on oil companies with annual sales of above $250 million.

Consumer prices rose at a rapid seasonally adjusted annual rate of 6.5 percent in January, up markedly from the December rise of 2.6 percent. Over the past three months, consumer prices have risen at about a 4 percent pace. Food prices soared at an annual rate of more than 25 percent in January and largely accounted for the increase in the overall index. In light of the continuing rapid run-up in prices of agricultural products at the wholesale level, the outlook for consumer food prices does not appear encouraging. Prices of nonfood commodities were unchanged in January, and over the past year such prices have climbed only about 2.4 percent. The advance of services prices moderated to a 2.7 percent annual rate of increase in January, compared with a 4.5 percent rise in the previous month.

The Business Situation

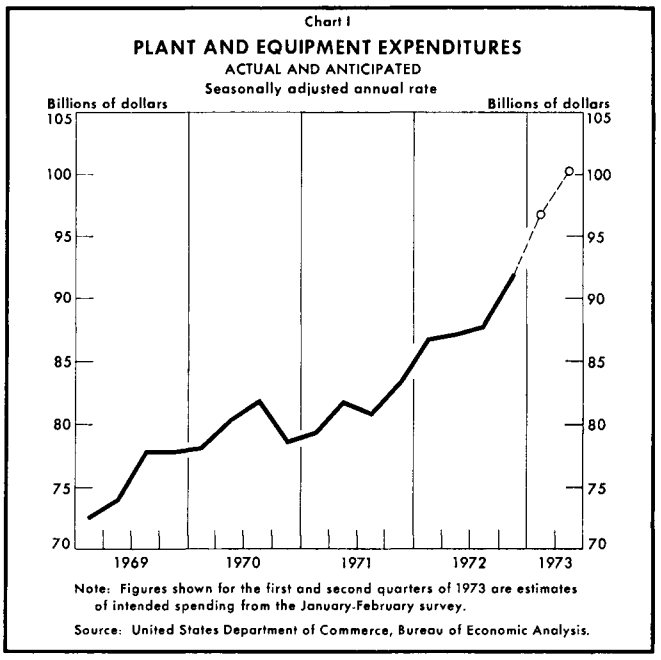
The economy continues to exhibit substantial strength. Industrial production moved ahead at a rapid rate in February, exceeding increases in the two preceding months. According to the latest Commerce Department survey, businesses have revised upward their plant and equipment spending plans for 1973. Further indication of the strength in the capital goods area is provided by the record jump in capital appropriations by large manufacturers in the fourth quarter. Total business inventories rose in January at the fastest rate in over six years, and further gains in inventory spending appear likely in the months to come. In February, the pace of residential construction activity remained robust, with housing starts only slightly below the high January mark. Retail sales in the January-February period were well above the December level, and sales of domestic passenger cars reached a record seasonally adjusted annual rate of 10.6 million units in March. The strength of the expansion has also been evident in the labor market. Employment rose sharply in both February and March, and this was accompanied in February by large increases in both the average workweek and overtime hours in manufacturing.

On the other hand, the outlook for prices is very disturbing. Wholesale prices in March skyrocketed at a seasonally adjusted annual rate of nearly 30 percent, the largest monthly increase since January 1951. While prices of farm products and food posted the most dramatic advances, prices of a wide variety of industrial commodities experienced distressingly large increases as well, some of which doubtless reflected a bunching of price rises that had previously been restrained by the Phase Two controls. These wholesale price increases are likely to be reflected in retail prices in months to come. Even in February the consumer price index advanced at the fastest rate in twenty-two years. Average hourly earnings rose only modestly in March and over the first quarter as a whole, but recent price developments may have jeopardized the chances of continued moderation of wage increases.

INDUSTRIAL PRODUCTION, CAPITAL APPROPRIATIONS, ORDERS, AND INVENTORIES

Industrial production is estimated to have expanded in February at a seasonally adjusted annual rate of 9 percent. This advance, which was larger than the increases in the two previous months, was widely distributed among final products. Business equipment output climbed strongly following a large rise in the previous month. Production of consumer goods moved up further in February, paced by an exceptional increase in durable goods output. To a considerable extent, this gain probably reflected the acceleration in production of domestic automobiles. Passenger car output rose to a seasonally adjusted annual rate of 10.1 million units in February and dipped only slightly in March to 10 million units. By comparison, a total of 8.8 million cars was produced domestically in 1972. Furthermore, output of defense and space equipment rebounded sharply in February from its January decline.

According to the Commerce Department's most recent estimates, businesses increased their expenditures on plant and equipment substantially in the fourth quarter, expanding them by $4.3 billion to a seasonally adjusted annual rate of $91.9 billion (see Chart I). Over 1972 as a whole, such spending was 8.9 percent above that of 1971. This latest Commerce survey indicates a rise in outlays for plant and equipment in 1973 of 13.8 percent, about 1 percentage point higher than the increase indicated in the December survey. Manufacturers' outlays for plant and equipment are expected to post a gain of 18 percent, while spending by nonmanufacturing firms is anticipated to rise 11.4 percent. In a separate survey conducted by the Conference Board, the 1,000 largest manufacturing firms reported that their capital appropriations rose by a record 12 percent in the fourth quarter. In addition, cancellations declined and, consequently, appropriations net of cancellations grew at an even more rapid 15½ percent pace. This sizable expansion in appropriations was accompanied by



a further increase in the backlog of unspent funds, providing additional credibility for projections of sizable expansion in capital spending in 1973.

Preliminary data indicate that new orders placed with manufacturers of durable goods edged up $0.4 billion in February, after rising by a huge $1.9 billion in January. Increases in bookings for primary metals and household durables more than offset declines in orders for nondefense capital goods. Defense bookings rose $0.1 billion in the month.

In January the book value of manufacturing and trade inventories advanced $1.9 billion, significantly above the $1.3 billion average gain posted over the last five months of 1972 when the pickup in inventory spending began. Indeed, the January rise was the largest percentage increase in inventories since December 1967. Despite the recent advances in inventories, the overall inventory-sales ratio has declined for eight consecutive quarters. Moreover, in January, total manufacturing and trade sales rose $3.7 billion and the inventory-sales ratio fell further to 1.43, the lowest level in nearly seven years. Indeed, with the exception of two months in 1966, this was the lowest ratio of inventories to sales since early 1951, when inventories were undoubtedly depressed by events related to the Korean war (see Chart II).

Preliminary data suggest that inventory accumulation in the manufacturing sector has stepped up further. In February, the book value of these inventories swelled by $0.9 billion on a seasonally adjusted basis. The February increase went well beyond the pace experienced during the preceding six months when monthly gains in manufacturing inventories averaged $0.6 billion. The inventory advance in February was broadly based in both durables and nondurables. Shipments moved ahead $0.6 billion in the month, after increasing by a considerably larger amount in January. Unfilled orders climbed a large $1.6 million in February, and the inventory-sales ratio edged down further to the lowest level since March 1951.

PERSONAL INCOME, RETAIL SALES, CONSUMER CREDIT, AND RESIDENTIAL CONSTRUCTION

Personal income climbed substantially by $8.3 billion in February, compared with increases in January and December of $2.7 billion and $6.7 billion, respectively. The bulk of the February increase was attributable to wage and salary disbursements, which rose $5.7 billion. In turn, this gain stemmed primarily from substantial advances in both employment and hours of work. It should be noted, however, that recent movements in this series have been affected by a variety of special factors. For example, an increase in social security benefits boosted personal income by $1.1 billion in February. In contrast, income in January was depressed by a rise in the social security tax rate and base.

Consumer spending has remained very healthy in recent months. Seasonally adjusted retail sales rose $0.6 billion in February on the heels of a huge $1.3 billion gain in the preceding month. Sales of both durable goods and nondurable goods increased in both months. Sales of new domestic-type automobiles were at a substantial 9.9 million unit annual rate in February, and in March such sales moved up to a record 10.6 million units.

Another indication of the buoyancy of consumer activity has been the rapid growth of consumer credit. Total consumer credit outstanding expanded 13.9 percent in 1972, its fastest growth rate since 1959. This increase was paced by the rise in instalment credit, although noninstalment debt also posted a strong advance. Some $5.5 billion of the $16 billion increase in consumer instalment credit was in automobile loans. In January and February, seasonally adjusted consumer credit rose by $2.1 billion and $2.0 billion, respectively. Almost all of the increases occurred in instalment credit, which posted successive record gains in the two months (see Chart III). The expansion in instalment credit was reflected in rapid increases in both auto and nonauto instalment debt.

LABOR MARKET DEVELOPMENTS

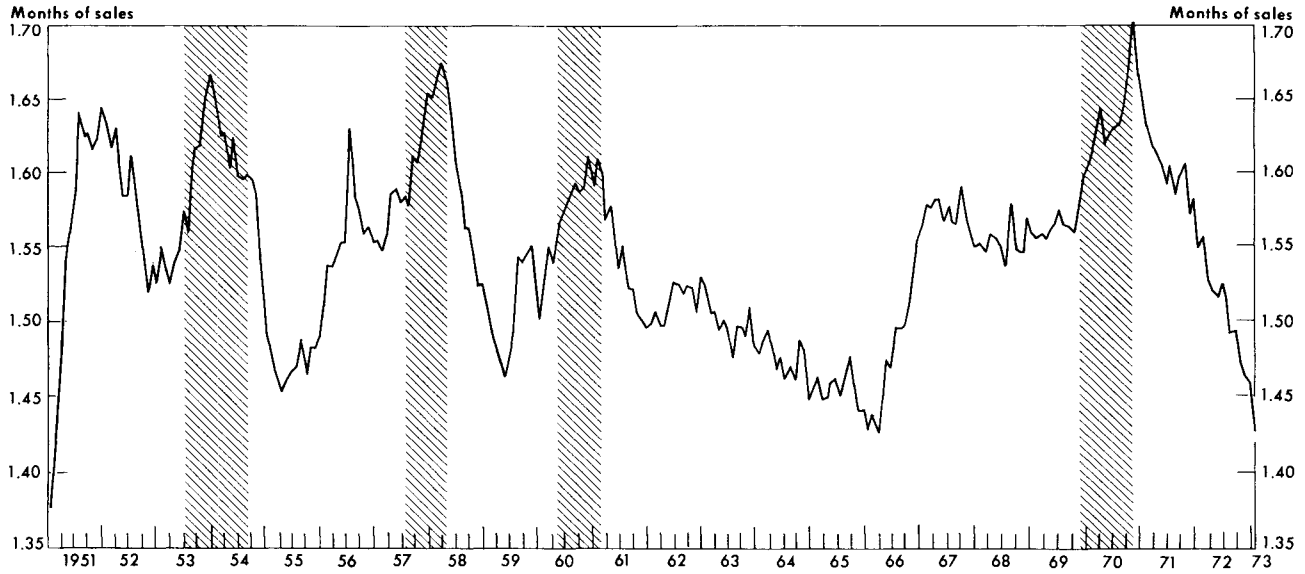
Recent developments in the labor market attest to the continuing strength of economic activity. According to the survey of households conducted by the Department of Labor, civilian employment rose by a huge 762,000 on a seasonally adjusted basis in March on the heels of a 572,000 increase in February. The civilian labor force also advanced by unusually large amounts of 648,000 and 699,000 in February and March, respectively. As a result, although the seasonally adjusted unemployment rate inched up to 5.1 percent in February, it declined to 5 percent in March. Taking a slightly longer viewpoint, the average unemployment rate for the first quarter of 1973 was 5 percent by comparison with 5.3 percent in the fourth quarter of 1972. Unemployment rates for adult males, adult females, and teen-agers were all below their fourth-quarter levels.

According to the separate survey of establishments, nonagricultural payroll employment in March moved up by 188,000 workers on a seasonally adjusted basis, following a huge 468,000 increase in the preceding month. Over the January-March period, gains in employment were broadly based with large increases in manufacturing and construction. The average workweek in manufacturing climbed sharply in February by 0.6 hour to 40.9 hours; overtime in manufacturing rose 0.2 hour to 3.9 hours, the highest since October 1966. Both the average workweek and overtime in manufacturing remained at these levels in March.

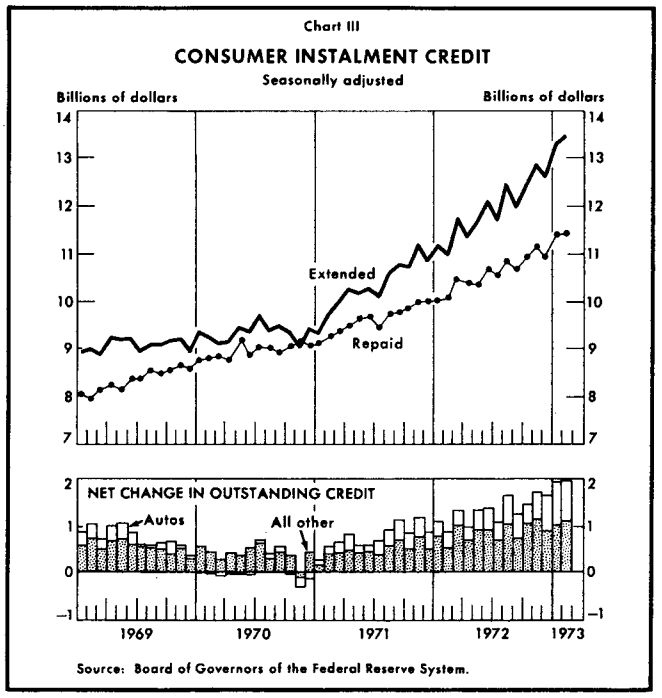
PRICES AND WAGES

Although an initial Phase Three bulge doubtless accounts for some of the recent price increases, the latest information on prices points to serious inflationary problems. The rate of increase of consumer prices accelerated in February following already large advances in January. In February the consumer price index moved ahead at a seasonally adjusted annual rate of 9.8 percent, the largest monthly rise in twenty-two years. Food prices soared at an annual rate of 29.5 percent on the heels of a January advance in excess of 25 percent. In a move to prevent meat prices from rising above the already high levels that they had reached, President Nixon on March 29 announced the imposition of price ceilings on beef, pork, and lamb at the wholesale and retail levels but not on farmers' live animal sales. Prices of nonfood commodities

Chart II
BUSINESS INVENTORY-SALES RATIO
Seasonally adjusted



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



moved up at a 6.1 percent seasonally adjusted annual rate in February. These prices had been steady in the previous month. Prices of services, which are not adjusted for seasonal variation, climbed at a 4.5 percent annual rate, also faster than the January increase.

Wholesale prices exploded in March at a seasonally adjusted annual rate of nearly 30 percent, the most rapid increase since January 1951. Prices of farm products and processed foods and feeds shot upward at a 74 percent seasonally adjusted annual rate, well above the already extremely rapid pace of the two preceding months. Prices of industrial commodities in March rose sharply at a seasonally adjusted annual rate of 15 percent, also the largest increase since January 1951. The March rise in industrial prices marked the second consecutive month of inordinately large advances. While the increases were widespread among industrial product groupings, particularly large advances were registered in prices of lumber and wood products, metals and metal products, textiles and apparels, and chemical and allied products.

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 modest 4.3 percent annual rate in March. The increase over the first three months of the year was only 2.8 percent. In the past six months the rate of increase in wages has been a moderate 5.4 percent. This is an encouraging development, to be sure, but continued moderation in wage increases may be very difficult to achieve in view of the steep increases in prices—especially food prices—that have occurred recently.

Beginning with the May 1973 issue, the *Monthly Review* will be distributed using automated procedures for mailing list maintenance, packaging, and mailing. In addition, delivery times will be reduced for most Eastern Hemisphere subscribers by airlifting copies to Amsterdam, where they will be forwarded via surface mail. Copies sent to United States and other Western Hemisphere subscribers will continue to be mailed from the New York area.

The following procedures will be initiated with the change from manual to automated handling of the *Review*. Multiple-copy subscriptions will be divided and packaged in envelopes containing no more than 10 copies each. Subscribers' names and addresses will be edited to fit a computer format of four 30-character lines. Special codes of "key" parts of subscribers' names and addresses will be used to identify their subscriptions.

Please allow an extra week for delivery of the May issue. Unforeseen problems may delay the first issue using automated procedures. But if you do not receive your copies within a reasonable time after the normal monthly delivery date, please call (212) 732-5700, extension 169, or write the Public Information Department at the Federal Reserve Bank of New York, New York, N.Y. 10045.

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.

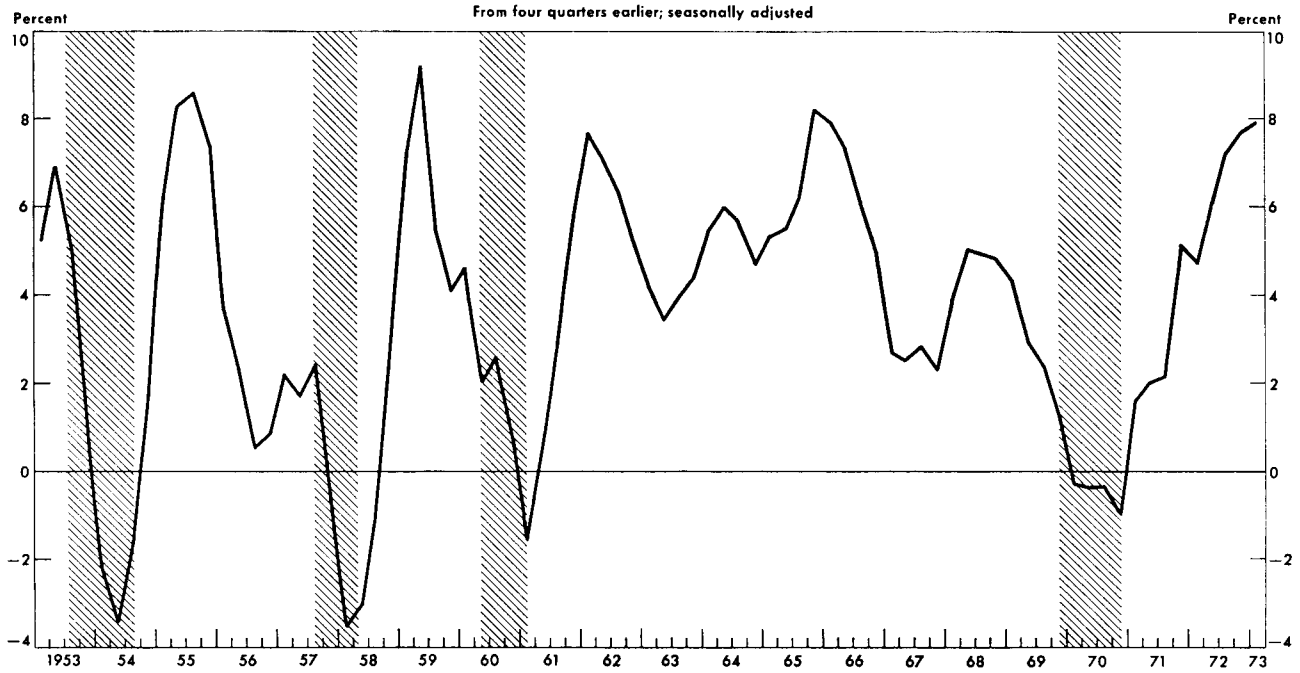
The first-quarter increase in current-dollar final expenditures—GNP net of inventory accumulation—amounted to a very strong $43 billion (see Chart II), or 15.3 percent at an annual rate. In real terms, final spending rose at a 9.1 percent annual rate, somewhat above the gain in the preceding quarter. 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.

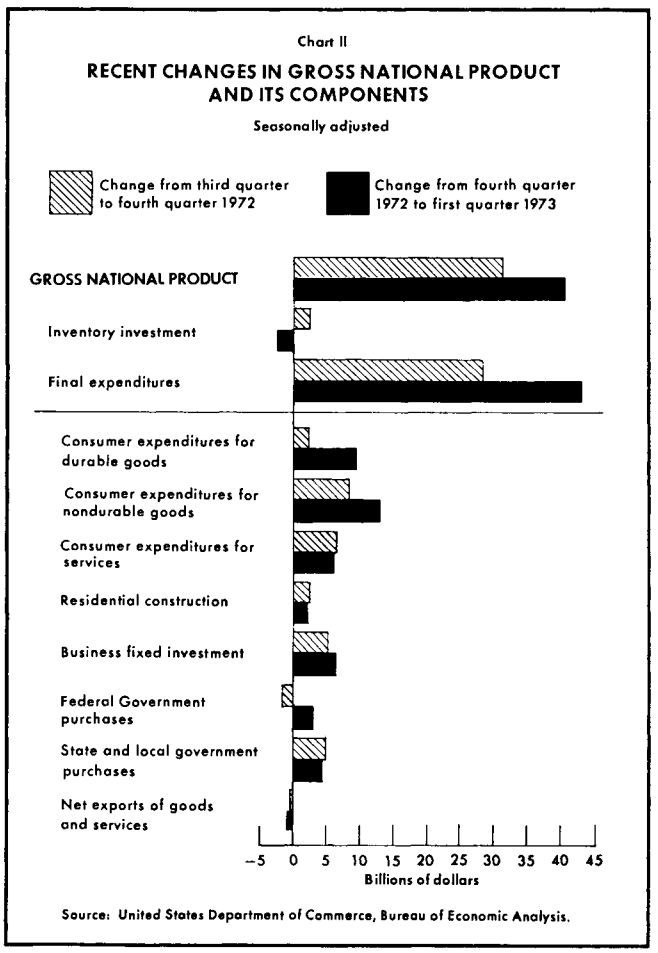
The rapid advance in consumer spending was accompanied by a healthy $19.3 billion increase in personal income. It would have been about $5 billion larger had it not been for an increase in the rate of social security contributions at the beginning of the year. The primary source of the advance in personal 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. Hous-

ing 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.

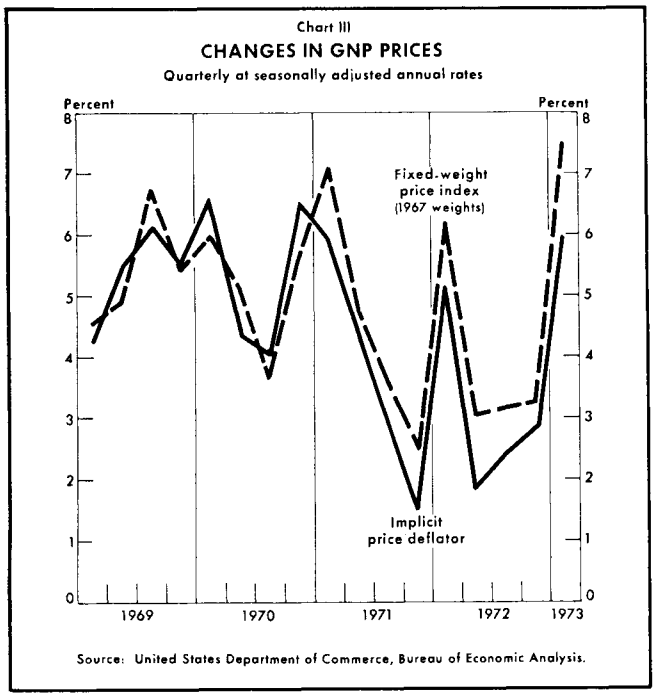


PRICE DEVELOPMENTS

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.

The Business Situation

Most sectors of the economy continue extremely strong. Industrial production and personal income rose rapidly in April. While new orders for durable manufactured goods declined in that month, the backlog of unfilled orders has climbed sharply thus far this year, suggesting further sizable increases in output accompanied by shortages and delays. Exceptionally low inventory-sales ratios, moreover, suggest the likelihood of strong inventory accumulation in coming months. Only residential construction is showing clear signs of weakening, as private housing starts in April fell to their lowest level in eighteen months. The unemployment rate remained unchanged at 5 percent in May, as both the civilian labor force and employment rose slightly.

Amidst the robust economic expansion, pressures on capacity and resultant demand pressures on prices are becoming increasingly severe. The revised fixed-weight price index for gross national product (GNP) increased at an 8.2 percent annual rate in the first quarter, up from the preliminary figure of 7.5 percent.[1] Consumer prices, seasonally adjusted, rose at a 7.8 percent annual rate in April as the advance of both food and nonfood commodity prices remained distressingly rapid. Over the past three months, consumer prices have risen at an annual rate in excess of 9 percent. In light of pervasive reports of shortages and delivery delays, demand pressures on prices seem likely to persist for some time to come.

[1] The Department of Commerce has revised the increase in current-dollar GNP in the first quarter from a seasonally adjusted annual rate of 14.3 percent to 15.2 percent. Most of this change reflected an increase in prices, as the growth in real GNP was raised only slightly. Inventory investment was revised downward, while the estimate of final sales was raised. Corporate profits before taxes climbed $3.4 billion to a $99 billion seasonally adjusted annual rate.

INDUSTRIAL PRODUCTION, ORDERS, CAPITAL APPROPRIATIONS, AND INVENTORIES

The Federal Reserve Board's index of industrial production climbed in April for the eighteenth consecutive month. The preliminary data indicate that the index rose at a robust 11.8 percent seasonally adjusted annual rate in April. During the first four months of this year the index has climbed at a 10 percent annual rate, the same increase as that experienced over 1972 as a whole.

Vigorous growth in most of the major market groupings combined to make the April rise in industrial production much larger than in March. Output of materials and business equipment grew twice as rapidly in April as in the previous month, and production of intermediate products and defense equipment rebounded sharply from declines in March. Similarly, production of consumer nondurables recovered strongly after having been sluggish in February and March. However, the expansion of consumer durable goods output slowed somewhat from the brisk pace of the preceding two months. Assemblies of domestically produced passenger cars eased slightly from the seasonally adjusted annual rate of 10 million units in March to 9.9 million units in April. These assemblies edged up to 10 million units in May, bringing new car production in the first five months of the year to a prodigious annual rate of 9.9 million units.

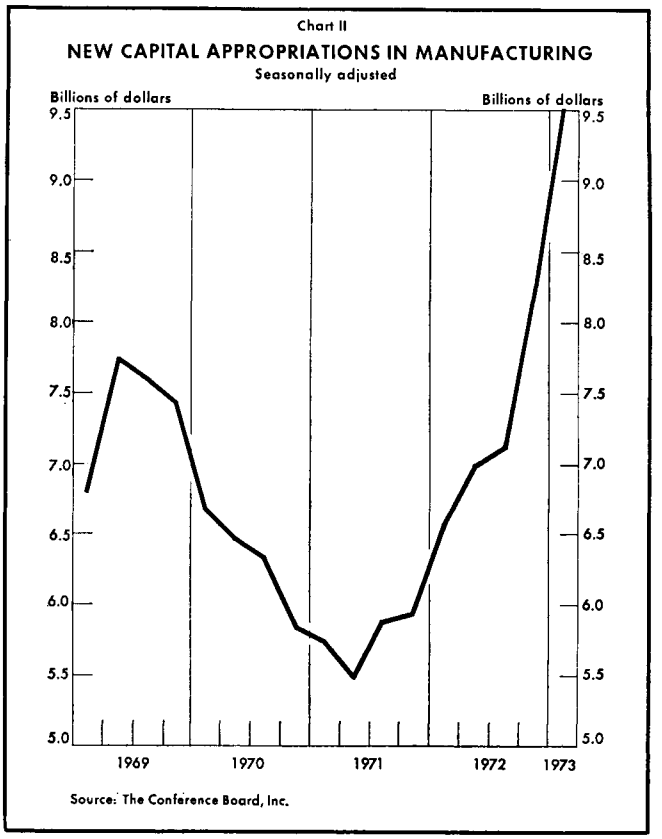
After increasing markedly over the first quarter, new orders for durable manufactured goods dropped in April by almost $0.9 billion (see Chart I), or about 2 percent, according to preliminary estimates. The decline was widely distributed among bookings for primary metals, machinery, household durables, and capital goods. At the same time, the backlog of unfilled orders continued to rise, as the level of new orders once again exceeded shipments. Since the beginning of the year, the seasonally adjusted stock of unfilled orders has increased at an exceptionally rapid

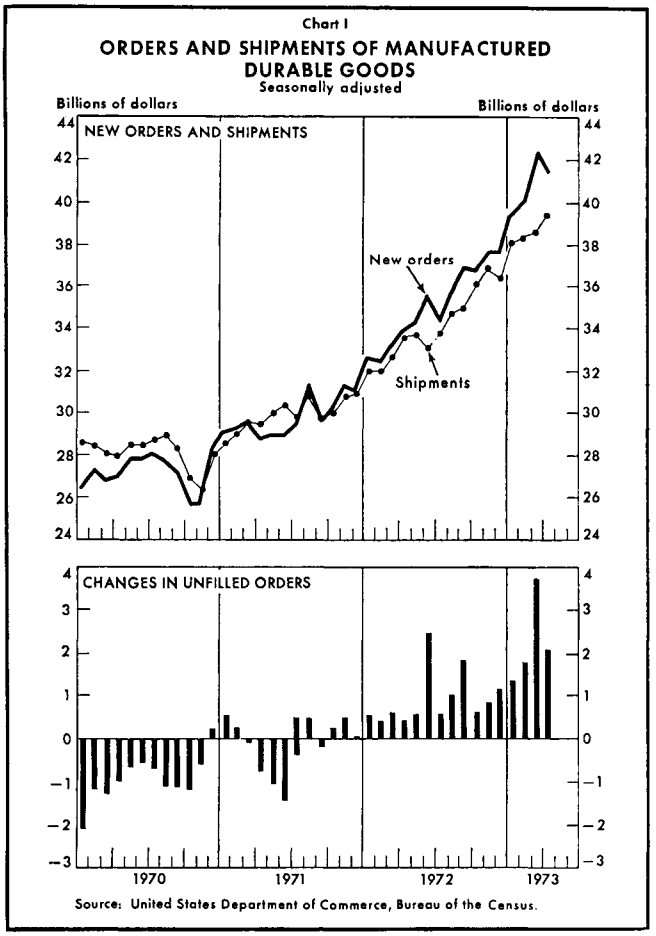
33 percent annual rate. While this suggests further sizable expansion in durable goods production in coming months, it may also be indicative of emerging shortages and lengthening delivery times in some industries.

According to the Conference Board, the nation's 1,000 largest manufacturers increased new appropriations for plant and equipment to a record $9.5 billion in the first quarter (see Chart II), a 15.5 percent gain over the level of the fourth quarter. The first-quarter advance was paced by large increases in the capital appropriations of durable good manufacturers, with particularly sizable gains in the automobile industry. This overall strength in appropriations corroborates earlier indications that capital spending by manufacturing firms will be robust throughout the year.

In March, seasonally adjusted manufacturing and trade inventories climbed $1.4 billion. The gain was smaller than the unusually large $2 billion increase averaged over the previous two months, but was about the same as the monthly rise from August to December of last year when the current inventory buildup began. The $5.4 billion run-up in the book value of inventories in the first quarter was the largest in twenty-two years. However, to a considerable extent the recent rise in book value inventories reflected sharply higher prices rather than an acceleration in the accumulation of physical stocks. In any event, nearly all of the March rise in inventory spending occurred in the manufacturing sector. Manufacturers added $1.2 billion to inventories and, in particular, the stocks of durable goods producers rose $800 million. Aggregate retail trade stocks moved up slightly but, reflecting declines in autos, furniture, and household appliances, inventories of durable goods declined. Wholesalers' inventories inched up only $50 million. Meanwhile, sales of manufacturing and trade firms continued their strong upward trend and, as a result, the inventory-sales ratio fell further in March to the lowest level since January 1951.

According to preliminary data, the book value of manu-





facturing inventories was unchanged in April, following the very large March increase. Small gains in the durable goods sector offset correspondingly small declines in nondurables. Since manufacturing shipments moved ahead strongly, the inventory-sales ratio declined further from its already very low March level.

PERSONAL INCOME, RETAIL SALES, AND RESIDENTIAL CONSTRUCTION

The growth of personal income quickened in April from the pace of the first quarter. The $7.6 billion advance raised personal income to $1,009 billion at a seasonally adjusted annual rate. Most of this increase was accounted for by a $6 billion gain in wage and salary receipts. Manufacturing payrolls alone rose $3 billion, with the bulk of the increase coming in durable goods industries.

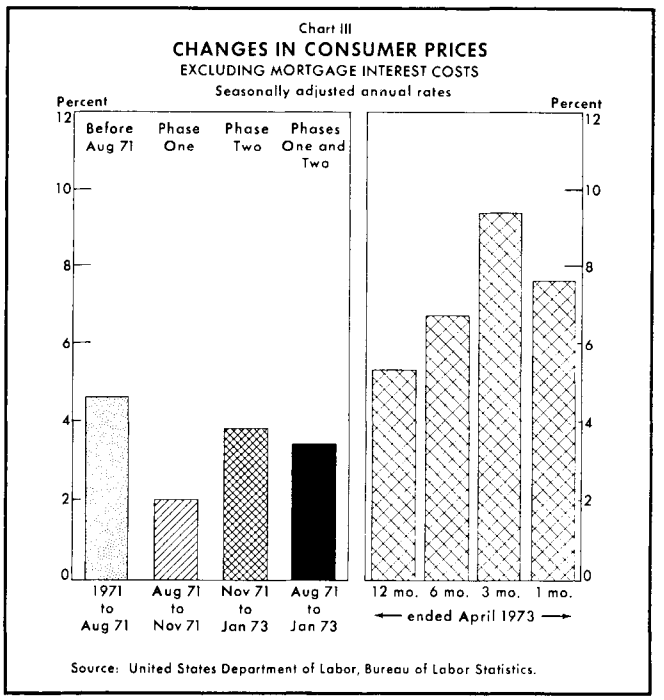
According to the advance report, retail sales slipped 1.5 percent in April on a seasonally adjusted basis following a strong and unusually steady climb. Inasmuch as this series typically moves somewhat erratically, one-month movements—especially in the advance data—are not likely to be very significant. Estimates of retail sales for both February and March were revised down slightly, but the data still show an extraordinary advance in the first quarter. The April drop in total sales reflected a widespread easing in spending. Outlays for furniture and appliances as well as for apparel and other soft goods declined. Sales of new domestically produced autos dipped to a still strong 9.8 million units at a seasonally adjusted annual rate, compared with the record 10.6 million units in March, and imported car sales were down slightly to 1.9 million units annually. In May, however, domestic auto sales moved up to 10.1 million units. While it is still too early to tell if some of the exuberance is consumer spending is beginning to fade, the April Census Bureau survey of consumer buying intentions revealed a pronounced decrease in consumer optimism. Plans to purchase most durable goods, including new cars and furniture and appliances, were noticeably lower than they were in the January survey.

There are more definite signs of slackening in residential construction activity. Although housing starts remain high by historical standards, they have declined for three months in a row. In April, a drop-off in both single-family and multifamily units led to a fall in total starts to 2.1 million units annually, their lowest level since October 1971. Moreover, building permits have fallen steeply over the first four months of this year to 1.8 million units. Newly issued permits were about a third less in April than the level of their December 1972 peak. While mobile home sales rose substantially in March (the latest data available), sales of new single-family homes declined markedly. Furthermore, the ratio of unsold new homes to sales of new one-family homes climbed rather sharply over the first quarter.

CONSUMER PRICES

The economy continues to exhibit serious price strains. Consumer prices rose at a seasonally adjusted annual rate of 7.8 percent in April, following even more rapid increases in the two preceding months. Over the entire three-month interval, consumer prices rose at a 9.2 percent annual rate. To be sure, a concentration of price increases early in Phase Three has contributed to some extent to the recent pace of inflation, but there are signs that significant demand pressures are at work as well. Food prices at the consumer level climbed at an annual rate of 18.3 percent in April, bringing the rate of rise in such prices thus far this year to an extraordinary 26 percent per annum. Prices of nonfood commodities advanced at a rapid 5 percent rate in April, somewhat below the pace of the previous month, and prices of services were up 3.6 percent on an annual rate basis.

Taking a somewhat longer perspective, total consumer prices increased 5.1 percent over the twelve months ended



April 1973. If mortgage interest costs are excluded, the growth was 5.3 percent. While changes in mortgage rates had little impact on the rate of increase in the overall consumer price index during the past year, they have had a sizable impact in some earlier periods. In early 1971, for example, mortgage rates fell sharply, thereby moderating somewhat the rise in the overall consumer price index. Consequently, in comparing recent price experience with that of the period before the Economic Stabilization Program, a better picture is obtained if mortgage interest costs are excluded. Chart III depicts annual growth rates in consumer prices excluding mortgage costs over several periods. As the chart illustrates, the 5.3 percent increase in consumer prices, excluding mortgage costs, during the past twelve months was faster than the rate of increase in these prices during the first eight months of 1971 prior to the price and wage freeze.

Food prices were up 11.5 percent during the twelve months ended April 1973, compared with an increase of only 4 percent in the preceding year. Prices of meats, poultry, and fish led the advance, climbing by more than 20 percent, and prices of fruits and vegetables moved up sharply as well. Nonfood commodity prices rose a moderate 3.2 percent over this same period, compared with 2.3 percent in the preceding year. Prices of nondurables—particularly home and auto fuel—increased relatively rapidly, but these gains were offset to a degree by generally modest rises in prices of durable goods. Prices of consumer services rose 3.5 percent over the twelve months ended April 1973, compared with 4.4 percent during the preceding twelve-month period.

LABOR MARKET DEVELOPMENTS

The survey of households conducted by the Department of Labor indicated that the civilian labor force rose by only 55,000 workers in May, the second small monthly advance after the huge increase in the first quarter. At the same time, civilian employment was also little changed in May, so that the unemployment rate remained at 5 percent for the third consecutive month. In addition, the unemployment rates of the major age-sex groups were virtually unchanged from the previous month.

According to the separate survey of the nation's establishments, payroll employment advanced by 148,000 workers in May following an increase of similar magnitude in the previous month. These recent increases are significantly smaller than the average monthly gains in employment experienced over the fourth quarter of 1972 and the first quarter of this year. Over these two quarters, the average monthly increase in payroll employment was approximately 275,000 workers. Both the average workweek and overtime in manufacturing fell slightly in May from their very high April levels.

The Business Situation

Business activity remains very strong although there are signs that capacity limitations are beginning to slow the advance. Industrial production rose further in May, but at a more moderate pace than that experienced earlier this year and in 1972. Inventory spending slowed in April; however, this slackening may have been largely unintended, as inventory-sales ratios remain inordinately low. The labor market displayed continued strength in June when the unemployment rate declined to 4.8 percent, the lowest level in more than three years. Retail sales increased in May but then declined in June.

The economy has faced a severe inflationary problem throughout 1973, with exceptionally rapid price increases at both the wholesale and retail levels. While some of these increases reflected a transitory price bulge, there are indications that the strength of demand has contributed substantially to the inflation. Many industries are reported to be operating at or near capacity, and there is evidence of serious delivery delays and shortages of more and more products and materials. On June 13, President Nixon imposed a freeze on virtually all prices, with the exception of prices of raw agricultural commodities sold at the farm level, for a maximum duration of sixty days. The latest price statistics, reflecting developments before the imposition of the price freeze, are very disturbing. Consumer prices increased in May at an annual rate in excess of 7 percent. Wholesale prices surged in that month and rose even more rapidly in June at a 31 percent rate, bringing wholesale price rises for the first half of the year to an extraordinary seasonally adjusted annual rate of 22 percent. While it will be some time before the impact of the freeze is evident in the price statistics, there are reports that serious distortions and increased shortages have already arisen in some industries. To avoid further distortions, it is desirable that the freeze end as quickly as possible. The Administration is in the process of devising a controls program more stringent than Phase Three to deal with inflation, but these measures have not yet been announced.

INDUSTRIAL PRODUCTION, CAPITAL SPENDING, ORDERS, AND INVENTORIES

Industrial production increased at a somewhat reduced pace in May. According to the Federal Reserve Board index, production climbed at a 5.9 percent seasonally adjusted annual rate in that month. This marked the smallest expansion in industrial output in ten months and came on the heels of a revised April hike of about 8 percent. Over the first five months of the year, industrial production has risen at an 8.5 percent pace by comparison with an increase in excess of 10 percent over 1972 as a whole. This recent slowing notwithstanding, production has now advanced steadily on a month-by-month basis since October 1971. The last time output increased consistently over such an extended period was the interval from November 1964 through October 1966 (see Chart I).

Output of business equipment and consumer goods increased considerably in May. Production of business equipment climbed at a 12.3 percent annual rate following an even more rapid expansion in April. Over the first five months of 1973, business equipment output has risen at an annual rate of 16.2 percent, well above the 13.4 percent rate of advance posted in 1972. Production of consumer goods increased at an 8.3 percent rate in May after a very small gain in the previous month. On the other hand, output of industrial materials grew at a much slower annual rate of 2.8 percent. However, this slowing may be a reflection of capacity limitations in some industries which have precluded firms from expanding output to meet demand. Output of defense and space equipment fell off again in May after spurting in April.

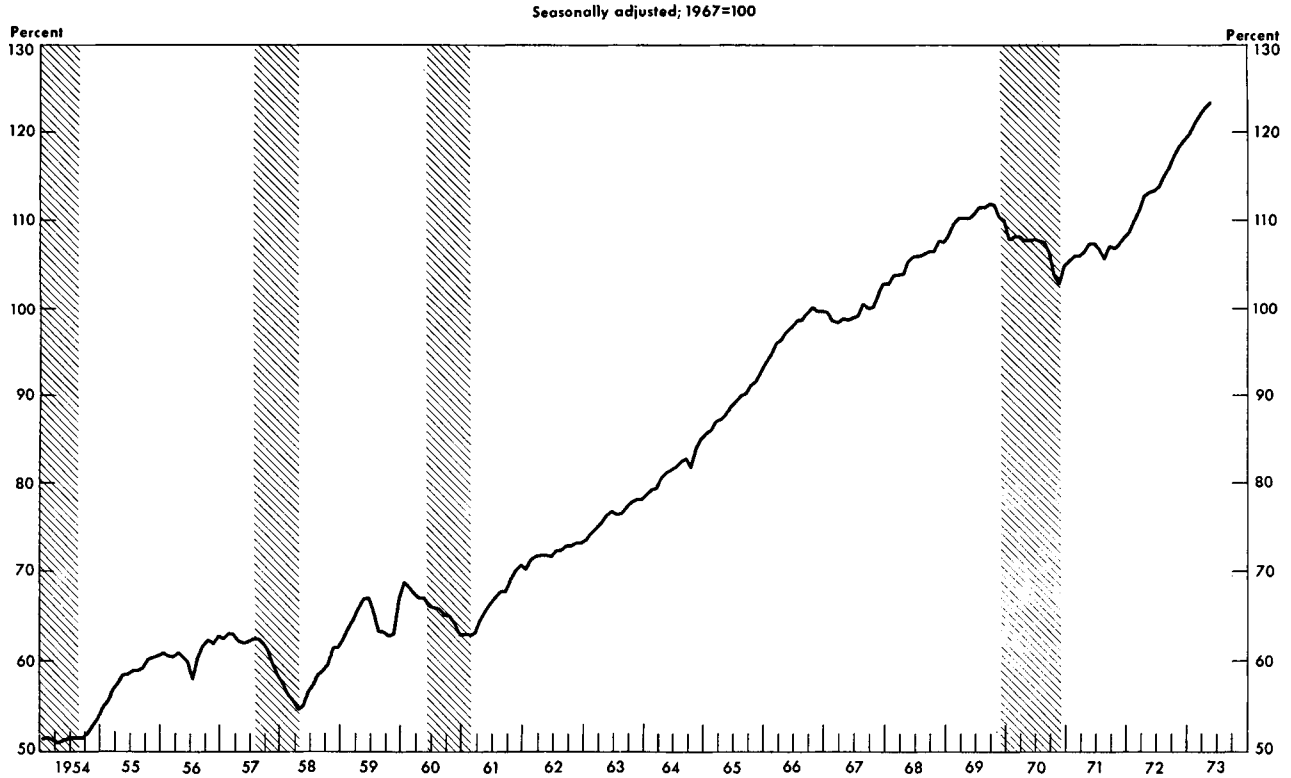
According to the Commerce Department's most recent estimates, businesses increased their expenditures on plant and equipment by $4.3 billion in the first quarter to a seasonally adjusted annual rate of $96.2 billion. This gain was about equal to that registered in the fourth quarter of 1972. For 1973 as a whole, the latest Commerce survey

indicates a rise in outlays for plant and equipment of 13.2 percent, slightly less than the increase recorded in their previous survey. Nevertheless, if realized, this would be the largest expansion in capital spending since 1966. Manufacturers' outlays for plant and equipment are anticipated to increase 18.5 percent over the year, up sharply from the 4.5 percent rise posted last year. Spending by nonmanufacturing firms is projected to advance 10.3 percent, down slightly from the 11.5 percent gain in 1972.

Orders placed with manufacturers of durable goods rose $0.9 billion, or 2.2 percent in May. This gain constitutes some resurgence in orders following an April increase of less than 1 percent. Nevertheless, the past two months represent, on balance, a slowdown in new bookings relative to the extraordinarily rapid advances earlier in the year. (It should be noted that the data for new orders have recently been revised to reflect bench-mark and seasonal factor changes.) About one third of the May increase in orders was attributable to a large rise in bookings for primary metals. Bookings for capital goods industries increased in the month despite a decline in defense orders. The backlog of unfilled orders continued to rise strongly during May as it has for many months. Some of the buildup in the backlog may reflect overbooking, however, as delivery times have lengthened and some products and materials have come into short supply.

In April, the book value of total business inventories increased $1.2 billion following gains which averaged more than $1.8 billion per month over the first quarter of the year. The April inventory accumulation was the smallest since December. Moreover, it is doubtful whether this advance represents much, if any, increase in the physical volume of stocks, since it probably largely stems from sharply higher prices for replacement goods put into stock.

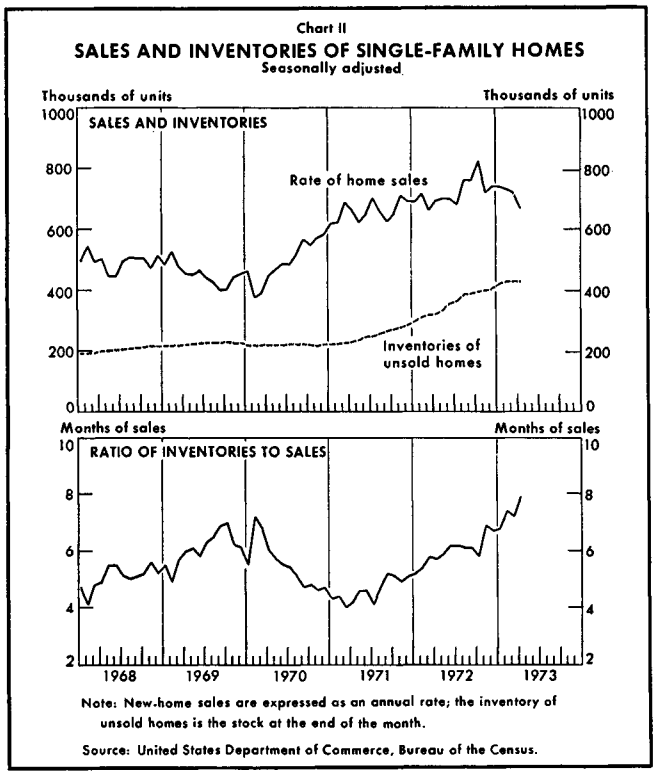
Chart I
INDUSTRIAL PRODUCTION
Seasonally adjusted; 1967=100



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: Board of Governors of the Federal Reserve System.

In any event, the book value of manufacturers' inventories rose modestly in April, as did retail and wholesale stocks. The ratio of inventories to sales for all businesses remained at a low level, still suggesting that a substantial buildup in inventories may be in the offing.

Preliminary data indicate that the book value of manufacturers' inventories rose $0.9 billion on a seasonally adjusted basis in May. Much of this increase in inventory spending was in durable goods industries. Durable shipments moved ahead by $0.5 billion in May, but nondurables shipments dropped off slightly. The overall inventory-sales ratio for manufacturing was virtually unchanged in May.



RESIDENTIAL CONSTRUCTION, RETAIL SALES, CONSUMER CREDIT, AND PERSONAL INCOME

Housing starts rebounded in May after declining for three consecutive months. The increase, to 2.4 million units at a seasonally adjusted annual rate, reflected a small gain in starts of single-family units and a substantial jump in multifamily starts. Newly issued building permits edged up in May as well, although, except for April, they were at their lowest level since early 1971.

Notwithstanding these May increases, there are signs of overbuilding in housing which suggest a further diminution in activity in the months ahead. While inventories of new unsold one-family homes were virtually unchanged in April (the latest data available), the number of unsold units remained well above levels posted in 1972 (see Chart II). Meantime, sales of new one-family homes dropped sharply to a seasonally adjusted annual rate of 667,000 units in April. This represented the lowest sales rate in over one year. Because of the sharp decline in sales, inventories of unsold new homes reached 7.9 months of sales, the highest level since the series began in January 1963. Over the first four months of 1973, the inventory-sales ratio for new homes averaged 7⅓ months, considerably above the already high average of 6 months posted in 1972. The April decline in mobile home shipments may also be an indication of the expected slowdown in housing over the final months of 1973.

Recent data provide evidence of some moderation in the growth rate of consumer spending. Of course, seasonally adjusted retail sales had grown at a very rapid 26 percent annual rate over the first three months of the year, and this pace was clearly unsustainable. After declining in April, retail sales rose in the next month but then fell again in June to $41.3 billion. Sales in each month of the second quarter remained below their March peak. For the most part, the slowdown in consumer spending has been concentrated in durable goods, particularly automotive products. In June, unit sales of new domestic-type automobiles moderated from their rapid May pace to a 9.1 million unit seasonally adjusted annual rate. During the first six months of 1973, sales of domestically produced automobiles averaged 10 million units. Sales of imported cars were at an annual rate of 1.8 million units in June, compared with 1.9 million units in both April and May.

Another hefty advance was recorded in consumer credit in May, when the stock of total consumer debt outstanding rose $2.2 billion on a seasonally adjusted basis. By comparison, total consumer credit had increased $1.7 billion in April and on average $2.1 billion over the first three months of the year. In recent months, the apparent leveling-off in the rate of growth of total credit reflected the noticeable pickup in the rate of repayments of instalment debt, which may in turn have been related to the unusually large Federal income tax refunds.

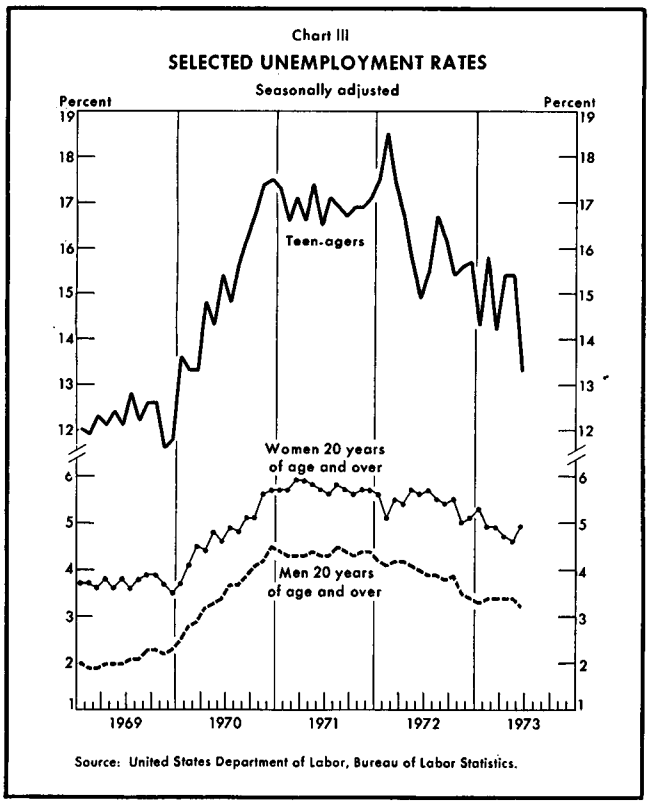
Personal income rose by a relatively modest $4.8 billion in May to $1,012 billion at a seasonally adjusted annual rate. Over the first five months of the year, personal income has climbed an average of $5.9 billion per month.

In May, a gain in wage and salary disbursements of $3.1 billion accounted for much of the rise, with the remainder of the increase resulting primarily from gains in interest income and in transfer payments.

LABOR MARKET DEVELOPMENTS

There are clear indications of continued strength in the labor market. According to the survey of households conducted by the Department of Labor, civilian employment increased sharply in June, after rising modestly in the two preceding months, and the overall rate of unemployment dropped to a seasonally adjusted 4.8 percent, the lowest it has been in more than three years. Data on the unemployment rates of major age-sex groups indicate that the unemployment rate for adult men edged down to 3.2 percent in June, while the more volatile teen-age unemployment rate fell dramatically (see Chart III). On the other hand, the unemployment rate for adult women rebounded to the level prevailing in February and March of this year.

Payroll employment rose by about 200,000 workers in June, a somewhat smaller gain than those recorded on average in earlier months of the year. Nevertheless, the 4 percent annual rate of growth in payroll employment during the first half of 1973 is slightly above the pace of expansion of the previous year, and it may well be that the strength of the labor market is greater than this comparison suggests. The data on labor turnover rates in the manufacturing sector of the economy provide support for this view. The rate at which workers are newly hired climbed to 4.3 per 100 employees in May, the highest level since early 1966. Throughout the first five months of the year, the new hire rate was running more than 23 percent above the average for 1972. At the same time, there was a marked expansion in job vacancies. Over the first five months of 1973, the increase in seasonally adjusted job vacancies amounted to almost 40 percent at an annual rate.



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

PRICES AND WAGES

The economy has faced a severe inflationary problem throughout 1973. Wholesale prices soared at a 20.5 percent seasonally adjusted annual rate over the first five months of the year, while consumer prices advanced at a very disturbing 8.2 percent rate. To be sure, some of these increases doubtless reflected a transitory price bulge, following the introduction in January of the largely voluntary Phase Three of the controls program. Moreover, a bunching of price increases probably resulted as some firms raised prices in anticipation of the adoption of more stringent controls. Nevertheless, there are also indications that the recent strength of demand has contributed measurably to the inflation. Many industries are reported to be operating at or near capacity, and there is evidence of serious delivery delays and shortages of more and more products and materials.

In this environment, President Nixon announced on June 13 a freeze on virtually all prices, with the exception of prices of raw agricultural commodities sold at the farm level, for a maximum duration of sixty days. The Administration intends to use this period to devise a controls program to replace Phase Three. During the freeze, prices are limited to their highest levels reached between June 1 and June 8. Wages and interest rates were not frozen but remain subject to Phase Three guidelines; in another development, the Committee on Interest and Dividends recently liberalized the rules regarding corporate dividend payments.

The impact of the freeze will not be evident in the price statistics until the July data are released sometime in August. The latest data, covering developments before the imposition of the freeze, present a very distressing picture. In June, wholesale prices rose at a disastrous 31.2 percent

seasonally adjusted annual rate. Wholesale prices of industrial commodities alone climbed at a 12.4 percent rate, about the same rate of advance as that experienced over the preceding five months. Meanwhile, wholesale prices of farm products and processed foods and feeds renewed their unprecedented advance in May and then surged upward at a seasonally adjusted annual rate in excess of 79 percent in June. These last months have pushed wholesale agricultural prices up at an almost unbelievable 47.5 percent annual rate over the first six months of the year.

Consumer prices continued to spiral upward in May, advancing at a 7.3 percent seasonally adjusted annual rate. Price increases at the consumer level have slowed somewhat over the past few months, leaving the May gain more than 1 percentage point under the rate of increase posted over the first four months of the year. By other standards, of course, this advance is still very rapid. For example, consumer prices rose 3.4 percent over 1972. The May advance in food prices, at a 14 percent seasonally adjusted annual rate, is substantially below the 26 percent rate of increase registered during the first four months of 1973. Nevertheless, it is almost three times as great as the increase in food prices in 1972. Nonfood commodity prices, climbing at a 5 percent seasonally adjusted annual rate in May, showed little change from their pace of the previous three months. Higher prices for apparel, used cars, and gasoline accounted for most of the May rise. Prices of consumer services, which are not seasonally adjusted, advanced at a 4.5 percent annual rate in May.

Recent hikes in wage rates have continued to be fairly moderate. In June, the average hourly earnings of workers in the private nonfarm sector rose at a 6 percent seasonally adjusted annual rate. Adjusted for overtime hours in the manufacturing sector and for shifts in the composition of employment among industries, the rise in average hourly earnings was a more rapid 7.7 percent. So far this year, however, the pattern of monthly advances in hourly earnings has been rather erratic, perhaps because the timing of pay raises has been affected by the controls program. As a result, it may be preferable to examine the growth in wage rates over periods of several months. Over the five months ended in June, adjusted average hourly earnings of workers in the private nonfarm economy have increased at a 5.8 percent annual rate, the same rate as that experienced during the preceding twelve-month period.

The Business Situation

The expansion in economic activity has slowed in recent months, but inflationary pressures have remained extremely severe. In view of the persistent buildup in the backlog of unfilled orders, continued pressures on capacity, and rather widespread shortages of materials and skilled labor, much of the slackening in real growth probably reflects supply limitations. While consumer spending for durable goods and new housing moderated in the second quarter from the very high levels experienced earlier this year and in 1972, it is not possible at this time to determine whether a significant easing of consumer demand is under way. In any event, the price freeze may be temporarily boosting consumer expenditures, and further gains in business inventory and capital spending seem likely in the months ahead. During July the unemployment rate dipped to 4.7 percent, the lowest in more than three years, but both employment and the labor force were essentially unchanged from their June levels.

Price behavior remains a source of very serious concern. Over the first half of the year, both the implicit price deflator for gross national product (GNP) and the consumer and wholesale price measures climbed at the fastest rates in more than twenty years. While some improvement in the statistics as a result of the price freeze has already materialized, demand pressures remain excessive. The Phase Four controls program should serve to spread out the rise in prices as the freeze is ended, but inflation will remain a serious problem so long as aggregate demand continues overly strong.

GROSS NATIONAL PRODUCT AND RELATED DEVELOPMENTS

The market value of the nation's output of goods and services rose $28.5 billion during the second quarter to a seasonally adjusted annual rate of $1,271 billion, according to preliminary Department of Commerce statistics. Measured in current dollars, GNP climbed at a 9.5 percent seasonally adjusted annual rate, well under the pace of expansion in the first quarter. Nearly three fourths of the second-quarter advance in GNP reflected an increase in prices. After adjustment for the price rise, real GNP moved ahead at a 2.6 percent annual rate in the April-June period, the slowest advance since the 1969-70 recession. Along with the preliminary data, the Commerce Department released its annual revisions of the GNP data going back through 1970. The estimate of growth in real GNP in the first quarter of this year was revised upward to an exceptionally rapid 8.6 percent per annum. Due mainly to the strong growth in the previous quarters, the increase in real GNP over the four quarters ended in June stands at 6.2 percent (see Chart I).

To a considerable extent, the slowdown in the growth of economic activity in the second quarter may have resulted from capacity limitations and shortages of skilled labor. Many important industries—such as automobiles, rubber, paper, petroleum refining, glass, cement, aluminum, and steel—are reportedly running at, or near, capacity. Output growth has slowed most noticeably in industries known to be operating close to capacity. For example, motor vehicle production, which has been running at overtime rates, rose at only a 1 percent annual rate in the April-June quarter, after shooting up at a 26 percent rate in the first quarter. Also, iron and steel production, which has been near capacity levels for almost a year, actually declined in the past quarter. Overall industrial production expanded by a smaller amount in the second quarter than in the first and, according to the Board of Governors of the Federal Reserve System index, the growth of output slowed to less than a 4 percent rate in June.

The pace of inventory investment picked up in the second quarter, although the increase was quite modest (see Chart II). Incomplete data indicate that the annual rate of inventory accumulation on the national income accounts basis amounted to $5.3 billion in the April-June period as compared with $4.6 billion in the January-March period. Inventory spending thus contributed $0.7 billion

to the growth of GNP. Larger inventory increases may well have been planned, but constraints on production and the high volume of sales may have prevented firms from realizing the desired additions to stocks. The ratio of the book value of total business inventories to sales dropped to extremely low levels in the first quarter, and hence considerable restocking of supplies was anticipated. Since the inventory-sales ratio still remains quite low by historical standards, prospects seem good for a further, sizable expansion in inventory spending in the months ahead.

The rise in final expenditures—GNP net of inventory accumulation—slowed in the second quarter. Final sales climbed $28 billion, down from the massive $46.8 billion advance of the first quarter. All the components of final spending moved higher, but most gains were relatively moderate. In particular, the increases in personal consumption and business fixed investment spending were considerably smaller than in the preceding quarter.

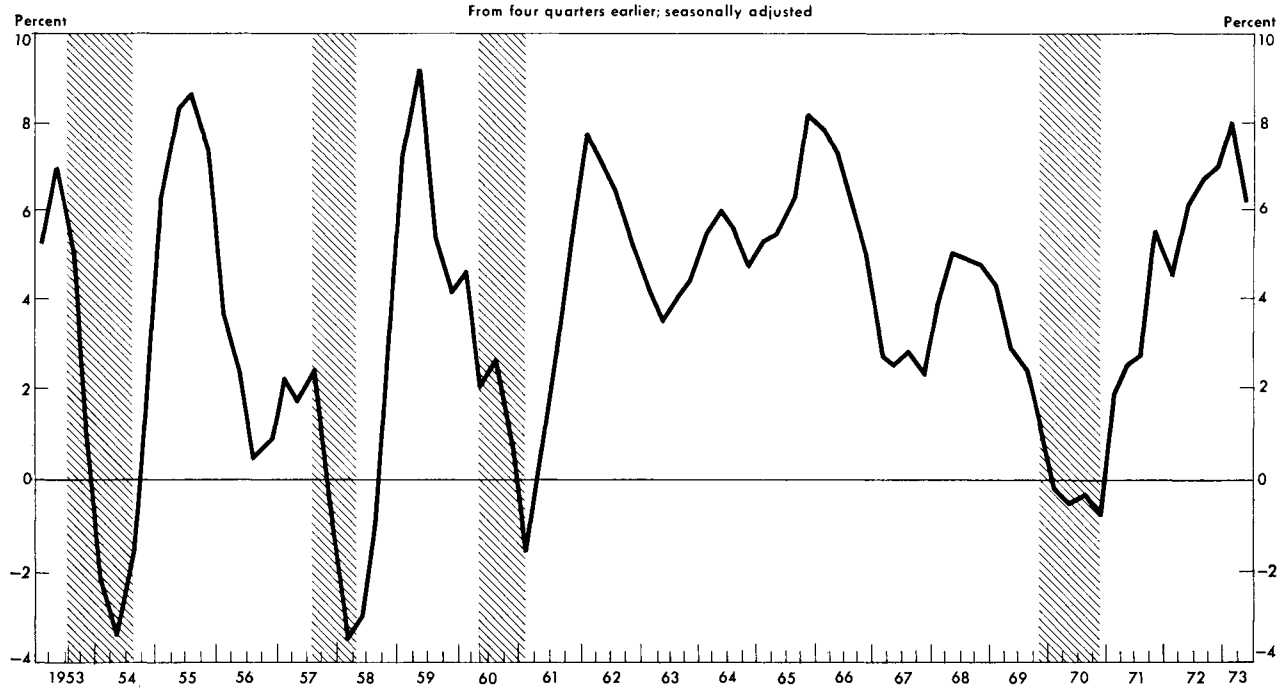
Personal consumption expenditures expanded by $15.7 billion in the second quarter, a sharp decline from the huge first-quarter advance of $26.8 billion. The increase in outlays on consumer durables shrank to $0.9 billion in the April-June interval following an enormous $9.3 billion burst in the initial quarter of the year. Indeed, after adjusting for higher prices, expenditures on consumer durables actually fell in the quarter as automobile sales and sales of other durable goods softened from their very strong first-quarter performance. The growth in spending on nondurable goods also moderated from the large increase in the previous quarter. On the other hand, the climb in outlays for services topped the gain of the first quarter.

The outlook for consumer spending in the months ahead is complicated by several factors. The price freeze, in effect on most products until August 13, could induce consumers to step up their purchases in the near term in anticipation of higher prices when the freeze ends. In July, domestic auto sales were at a healthy 10.3 million unit annual rate. On the other hand, increased uncertainty about the economic outlook may restrain consumer spending. Retail

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.

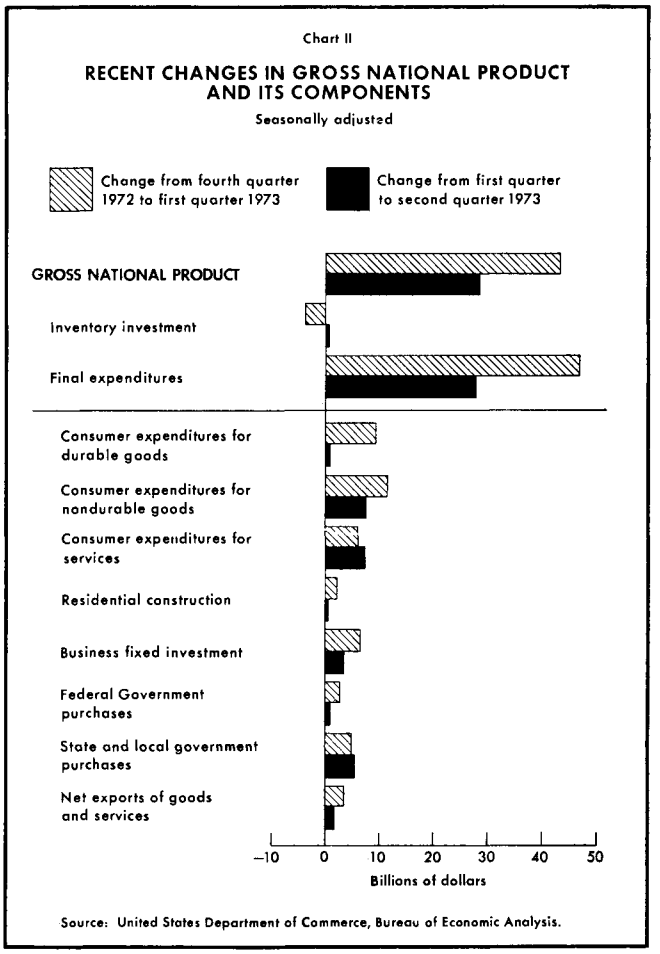
Source: United States Department of Commerce, Bureau of Economic Analysis.

sales remained below their March peak throughout the second quarter. Moreover, the University of Michigan's index of consumer sentiment has declined steadily since the third quarter of 1972 to reach in May its lowest level since the 1969-70 recession. According to the Michigan survey, consumers are concerned about both their personal financial circumstances and prospects for business activity in general. A more recent survey conducted by the Conference Board reported that consumers have reduced their plans to buy automobiles and homes from the high levels indicated in the spring.

In the latest revisions of the GNP data, the personal saving rate—the ratio of savings to disposable personal income—was significantly reduced for the past year, reflecting a larger rise in spending than previously reported. According to the revised estimates, the saving rate dropped sharply in the first half of 1972 and has changed little, on balance, since then. The slowdown of the growth in consumer spending in the second quarter was accompanied by a slight rise in the saving ratio to 6 percent, the rate that prevailed on average during much of the 1960's. By comparison, the saving rate stood at 5.9 percent in the first quarter of this year and at 5.8 percent in the second quarter of 1972.

Business fixed investment grew by $3.5 billion in the second quarter, only about half the strong expansion of the preceding three-month interval. This slackening was concentrated in spending for producers' durable equipment. In particular, purchases of trucks dropped off after a very strong performance earlier in the year. Notwithstanding this moderation, the expansion of business fixed investment was at a robust 17 percent annual rate over the first half of the year. This increase falls between the 13 percent expansion expected by the Commerce Department in its May survey of plant and equipment investment plans and the 19 percent rate projected in the McGraw-Hill spring survey which was supported in a special follow-up survey. In light of the diminishing reserve of unused productive capacity and the results of the capital spending surveys, it seems likely that investment outlays will remain strong in coming months.

Residential construction spending inched up by only $0.5 billion in the second quarter, providing additional evidence that the boom in housing is over. Other measures of housing activity confirm the slackening in home building apparent in the national income accounts and presage further weakening in residential building. Housing starts fell from an average 2.4 million units at an annual rate in the first quarter to a 2.2 million rate in the second quarter. Similarly, newly issued building permits were off 12 percent, relative to the first-quarter average.



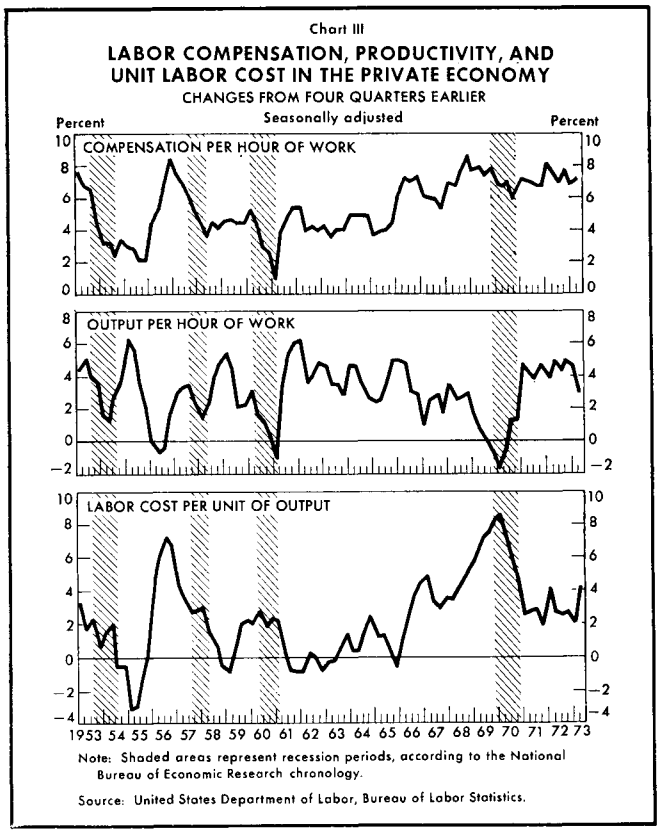
Government purchases of goods and services contributed about $6.5 billion to the second-quarter GNP advance. Expenditures of state and local governments increased by a substantial $5.5 billion, $0.5 billion above the rise of the previous quarter. The recent rapid gains in state and local government spending undoubtedly reflect the favorable budget position of many of these governments and the receipt of funds from general revenue sharing. Federal spending moved up by a modest $1 billion in the April-June period. Defense spending accounted for only a small portion of this increase.

WAGES, COLLECTIVE BARGAINING AGREEMENTS, PRODUCTIVITY, AND EMPLOYMENT

The rate of wage gains continues moderate, on balance. During the April-June period, wage and benefit increases agreed upon in collective bargaining situations

involving 5,000 or more workers remained at about the moderate pace of the first quarter. Settlements concluded in the first six months of 1973 provided for mean life-of-contract wage and benefit increases at a 6.2 percent average annual gain, compared with a 7.4 percent rate in the previous year. The latest figures represent a decline from the extremely high 1970-71 rates, when wage and benefit growth averaged 8.9 percent over the life of the contract. (These data do not include the cost-of-living adjustments contingent on movements in consumer prices.) In addition, the recent contract negotiations have been settled without disruptive strikes. During the first six months of this year the percentage of working time lost because of strikes was the smallest in nine years, even though contract negotiations involve nearly as many workers as in the peak years of 1970 and 1971. Of course, the labor calm may not persist in light of the negotiations in major industries scheduled for later this year.

In the second quarter, compensation per hour of work in the private economy rose at a 7.2 percent seasonally adjusted annual rate, considerably smaller than the 9.4 percent expansion in the January-March period. Since the first-quarter compensation data were inflated by greater social security taxes paid by employers, the large difference between the quarterly figures exaggerates the deceleration. The second-quarter rise in compensation is the same as the gain experienced during the four quarters ended in June (see Chart III).



The hourly earnings index—which is adjusted for interindustry employment shifts and overtime in manufacturing—is the closest available approximation of basic wage rates for the private nonfarm sector's 51 million production workers. In July, the index rose at a 4.9 percent seasonally adjusted annual rate, bringing the growth over the most recent twelve months to 6.1 percent.

Productivity, as measured by output per hour of work in the private economy, showed no growth in the second quarter after rising at a 3.9 percent annual rate in the January-March period. Excluding the farm sector, where productivity changes tend to fluctuate widely from quarter to quarter, productivity fell slightly in the second quarter, the first decline since the fourth quarter of 1970. The drop in nonfarm productivity came after six quarters of growth considerably above the long-run trend rate of increase. The abrupt halt in the increase in productivity shown in the preliminary statistics seems inconsistent with the small moderation in the expansion of industrial production. Since there was no productivity improvement to help offset the continued rise in compensation per hour of work, unit labor costs moved sharply higher at a 7.7 percent annual rate, the fastest rise since the first quarter of 1970.

The labor market changed little from June to July. According to the monthly survey of households, both the civilian labor force and employment decreased slightly in July following the exceptionally large gains recorded during the preceding month. The overall unemployment rate slipped to 4.7 percent, its lowest level in more than three years; in comparison, the rate of unemployment was 5.6 percent a year earlier. During July, the jobless rate for adult males moved down to 3 percent from 3.2 percent in June. Meantime, the unemployment rate for adult women was unchanged at 4.9 percent, and the volatile teen-age jobless rate rose from 13.3 percent to 14.4 percent.

In the separate July survey of establishments, nonfarm payroll employment generally continued at the June levels. An increase in employment in the service industries was largely counterbalanced by a decline in manufacturing employment. While the number of workers on factory payrolls declined during July, the average workweek of manufacturing production workers advanced 0.3 hours to 40.9 hours. Overtime remained at 3.8 hours per week.

PRICE DEVELOPMENTS

Prices continued to rise at unacceptably rapid rates up to the imposition of the price freeze on June 13. All of the major price measures—the implicit GNP deflator for the second quarter, the consumer price index, and the wholesale price index—gave clear signs of the severity of the inflation prior to the price freeze. While the freeze has already resulted in some improvement in the wholesale price index, it is doubtful that any abatement in underlying inflationary pressures has been achieved. The most severe price pressures have been concentrated in areas of extremely strong demand, such as food, fuel, livestock feed, and many unprocessed industrial nonferrous metals. In an effort to restrain the inflation, the Phase Four controls, scheduled for implementation on August 13, will allow only a dollar-for-dollar pass-through of cost increases in most industries. While the many special regulations covering specific industries considerably complicate the price picture, the narrow margin of idle productive resources in the economy suggests that inflationary pressures will remain strong.

According to the preliminary data, the implicit GNP price deflator surged at an extraordinary 6.8 percent seasonally adjusted annual rate in the second quarter, the fastest climb since the first quarter of 1951 when prices were affected by the Korean war. The rise in the April-June period came on the heels of the exceptionally large 6 percent rise in the initial quarter of the year. Rapid as these increases are, the fixed weight GNP price index, which is based on the composition of spending in 1967, has risen even more sharply in recent quarters. In the second quarter the fixed-weight index climbed at a 7.2 percent annual rate, and over the past year this index has advanced 5.5 percent. These figures probably give a better reading of the breadth and intensity of recent price pressures in the economy than does the implicit deflator.

At the retail level, consumer prices climbed in June at nearly a 7 percent seasonally adjusted annual rate. Over the first six months of 1973, consumer prices jumped at a 7.8 percent annual rate, the fastest rise in twenty-two years. Food prices have long been the chief culprit in the unsatisfactory consumer price situation. While the rate of increase in consumer food prices has braked from the extraordinary advance of the first quarter, these prices still moved upward at a very disturbing 11 percent annual rate in June. In the meantime, increases in the prices of nonfood commodities and services have been accelerating. The prices of gasoline, fuel oil, household durable goods, and used cars all rose sharply in June. Over the second quarter as a whole, prices of nonfood commodities climbed at a 5.3 percent annual rate by comparison with an increase in the first quarter at less than a 4 percent pace.

After skyrocketing over the first six months of the year, wholesale prices in July fell at a 17 percent annual rate, the steepest drop in twenty-five years. The first decline in the wholesale index in almost two years reflected a sharp plunge in the prices of farm products and processed foods and feeds. In turn, a drop in the price of soybeans, which have been subject to export controls, accounted for much of the decline in the agricultural commodities component. However, since the survey of wholesale prices was taken, the prices of many farm goods have climbed again, so that the improvement in the index is likely to be short-lived. The price freeze apparently has had some success in holding wholesale prices of industrial commodities steady; industrial prices rose at just a 0.7 percent annual rate in July.

The Business Situation

The latest information on business developments indicates that economic activity is continuing at a high level, although the pace of advance has evidently slowed somewhat in recent months.* It still is not clear, however, to what extent this moderation reflects a diminution of demand as distinct from the slowing effects of capacity limitations and supply bottlenecks. After rising rather modestly in recent months, industrial production exhibited a sizable increase during July. Inventory spending increased substantially in June, probably to a considerable extent the result of higher prices rather than an expansion of physical stocks. Retail sales rose sharply in July but were still only slightly above the previous peak reached in March. Despite the one-month rise in housing starts during July, other indicators more clearly point to a substantial slowing in residential construction activity.

The most recent changes in the Economic Stabilization Program dominated the behavior of consumer prices during July and have made it more difficult to gauge the underlying intensity of inflationary pressures. Nonfood consumer prices rose quite slowly during the month, but food costs registered a surprisingly large increase, given the fact that the food price data were gathered primarily during the period of the freeze. Prices for certain important commodities in the agricultural spot and futures markets soared even further around midsummer, but there were some tentative signs of declines during the latter half of August. While the impact of these movements on retail food prices is uncertain, Secretary of the Treasury Shultz has indicated that further substantial consumer price increases are expected in the next few months.

INDUSTRIAL PRODUCTION, ORDERS, AND INVENTORIES

According to preliminary data, the Federal Reserve Board's index of industrial production, which measures the physical volume of output of the nation's factories, mines, and utilities, rose at an 8.6 percent seasonally adjusted annual rate in July. In comparison, the growth in output had slowed to slightly less than a 5 percent pace during the preceding four months, after increasing by more than 12 percent over the year ended this past February. These rates of increase are based on recent revisions of the industrial production index, instituted partly to take account of new seasonal factors.

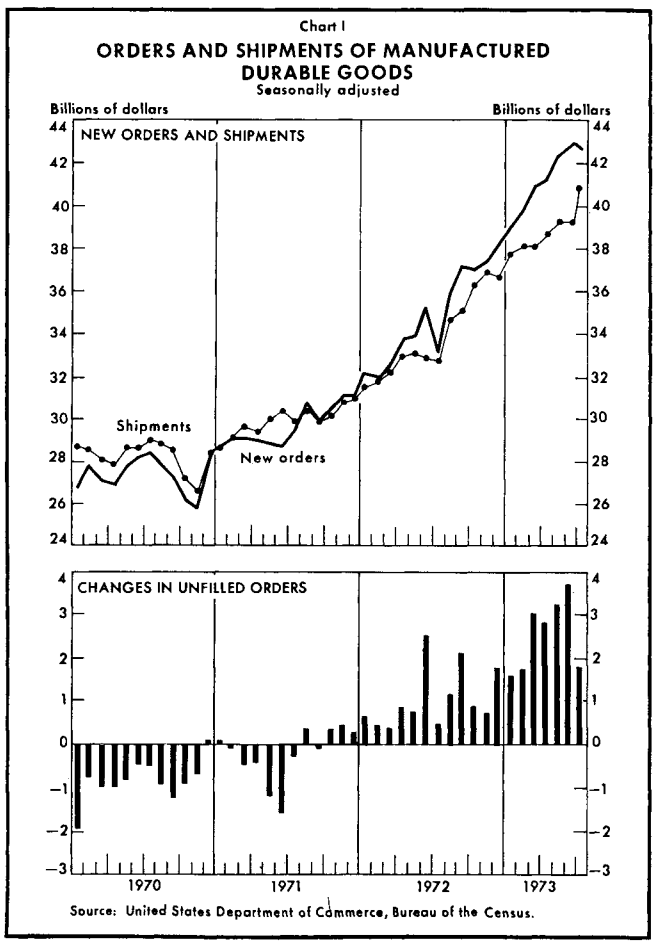
Gains in July production were widespread among market groupings. The output of industrial materials advanced at a 9.3 percent annual rate, with particularly rapid gains in durable goods materials. Production of textiles, paper, and chemical materials also increased sizably. On the other hand, iron and steel output showed no advance, as production has been close to capacity for several months. Output of business equipment advanced at a modest 3.9 percent annual rate in July. The slower growth of business equipment output probably resulted in part from capacity limitations on products such as trucks and buses. The production of defense and space equipment, which tends to show considerable month-to-month fluctuation, advanced rapidly in July.

Consumer goods output increased at a 6.4 percent seasonally adjusted annual rate in July, with production of appliances, television sets, and some household goods continuing to show rapid gains. Automobile production also advanced. Passenger car output reached 10.3 million units in July, a bit above the high production pace sustained during previous months of this year. July sales of domestic-type autos, at a 10 million unit seasonally ad-

* The estimate of second-quarter current-dollar gross national product (GNP) growth has been revised upward slightly from $28.5 billion to $29.5 billion. Inventory investment was lowered, while the estimate of final sales was raised. In real terms, GNP is now estimated to have grown at the even slower rate of 2.4 percent, compared with the initial estimate of 2.6 percent. The GNP price deflator increased at a 7.3 percent annual rate during the quarter, up from the preliminary estimate of 6.8 percent. Corporate profits before taxes (adjusted for changes in the inventory valuation adjustment) advanced $4.7 billion to a $109 billion seasonally adjusted annual rate.

justed annual rate, indicate that sufficient demand for such high production levels is being maintained. The current strong demand for autos may be, however, partly a result of consumer attempts to escape higher prices expected for 1974 models because of additional mandatory antipollution and safety features. There are signs, moreover, that the composition of recent automobile production has not fully matched that of consumer demand. Specifically, the demand for smaller vehicles with lower gasoline consumption has been relatively stronger than the call for larger autos. As a result, inventories toward the end of the model year contain a high proportion of large cars. Seasonally adjusted inventories at the end of July amounted to 1.7 million units, up from 1.6 million the month before and 1.5 million averaged over the first five months of this year.

Seasonally adjusted new orders placed with manufacturers of durable goods dropped by $0.3 billion during July (see Chart I), following the June increase of $0.6 billion. Excluding bookings for defense products which exhibit substantial month-to-month volatility, durables orders rose by $0.8 billion in July, compared with an increase of $0.2 billion in June. Nevertheless, there is some evidence that producers may be hesitant to accept new orders in areas where capacity is severely strained. While orders with primary metals producers were off $0.3 billion in July, bookings for machinery continued to expand at a robust pace.

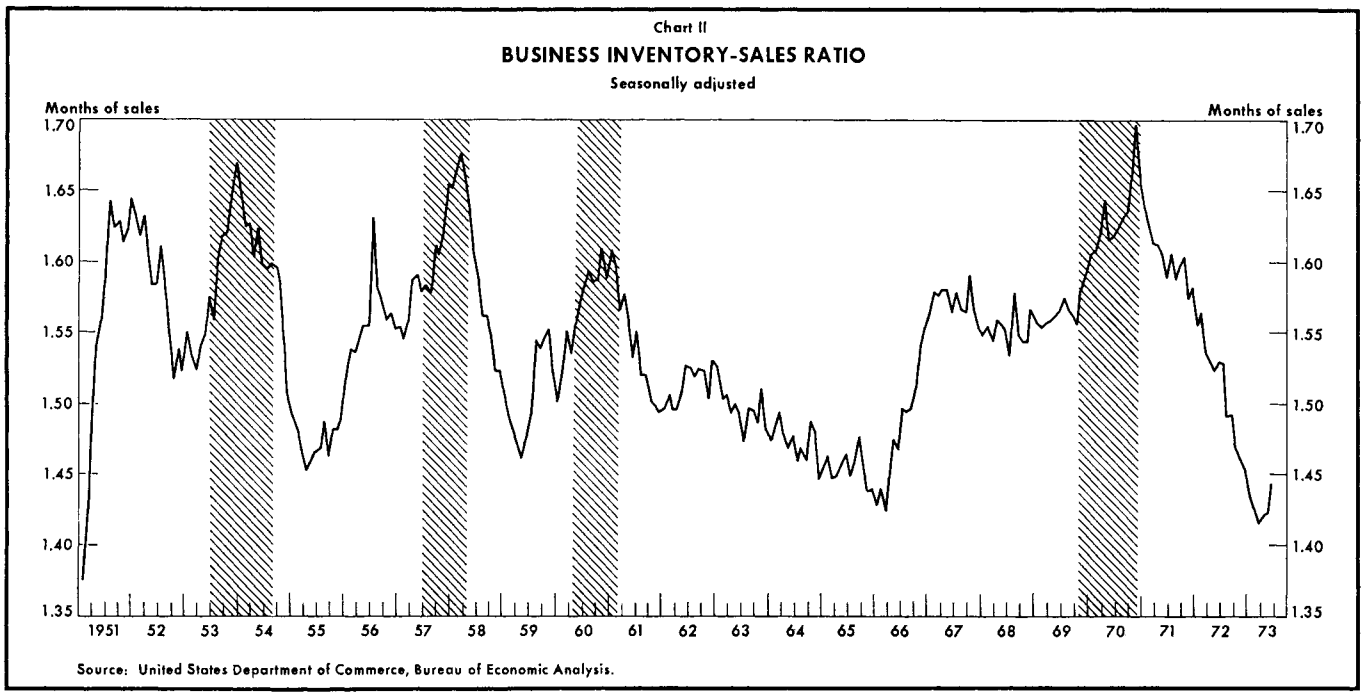


Even including the July decline, the rise in new orders for durables has been at a substantial 20 percent annual rate over the first seven months of this year. Some, but certainly not all, of this climb represents the impact of higher prices, insofar as the seasonally adjusted price index for durable manufactured goods rose at an 8 percent annual rate over the same period. During 1972, however, the rise in "real" bookings was probably considerably stronger, since new orders climbed by 23 percent in dollar terms while the durable goods price index rose by only 3 percent.

Although the backlog of unfilled orders increased again in July, shipments advanced more strongly so that the ratio of unfilled orders to sales declined for the first time since January. At 2.43, the ratio is still considerably above the levels reached in 1972, providing further evidence of the existence of reported supply bottlenecks. Moreover, a new index of capacity utilization for basic materials industries compiled by the Federal Reserve Board climbed to 94.4 percent during the second quarter of 1973, its seventh consecutive quarterly advance. The second-quarter rate is the highest ever recorded for the twelve industries included in the index since the beginning of the series in 1948.

According to a Conference Board survey, net new capital appropriations of the 1,000 largest manufacturing firms rose by 11.6 percent (seasonally adjusted) during the second quarter, following a 17.2 percent first-quarter rise. Excluding the rather volatile petroleum and coal category, net new appropriations moderated to a 4.3 percent rate of increase during the second quarter, compared with the extraordinary 22.3 percent first-quarter gain. The backlog of appropriated but unspent funds has increased strongly since the start of 1972, after falling steadily throughout 1970 and 1971. By the second quarter of this year, the backlog had climbed more than 40 percent above the year-earlier level and could serve to propel capital spending even if the growth of new appropriations slows substantially in coming quarters.

Total business inventories continued their rapid expansion on a book value basis in June and increased by



a large $2.6 billion, seasonally adjusted, following a $2.1 billion advance in May. These additions reflected substantial gains in inventories at the manufacturing, wholesale, and retail trade levels. Recent reports suggest that at least some inventory building has served to support rising production; moreover, firms are probably anxious to increase inventories as a hedge against anticipated shortages and future price increases. Nevertheless, much of the recent expansion in the book value of business inventories has probably resulted from continuing price inflation rather than from the accumulation of physical stocks.

The underlying inventory situation is placed in perspective when the ratio of inventories to sales is considered. The stock-sales ratio for all business has remained under 1.45 over the past six months (see Chart II). In comparison, the ratio remained below this level for a longer period only during one other episode—the Korean war year of 1950. In June, the inventory-sales ratio edged up to 1.44, as total business sales dropped off. It is too early to determine, however, whether this increase signals a turnabout in the downward trend of the inventory-sales ratio which has prevailed since late 1970.

According to preliminary data, the book value of manufacturers' inventories advanced by a strong $0.9 billion, seasonally adjusted, in July. This increase was below the very sizable June inventory buildup, but was somewhat above gains averaged over the first five months of 1973. July accumulation of nondurable goods was well above the monthly average for the first half of the year, while durables accumulation was slightly under its monthly average for the same period. Manufacturers' shipments moved ahead strongly in July, particularly in the durables sector, leading to a further decline in the already low inventory-sales ratio in manufacturing.

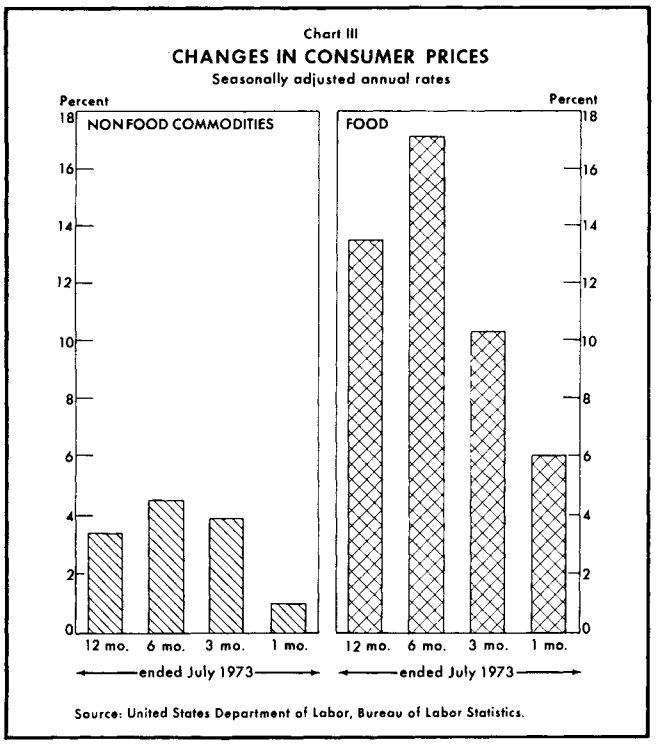
PERSONAL INCOME, CONSUMER DEMAND, AND RESIDENTIAL CONSTRUCTION

Personal income rose $7.3 billion in July, about the same increase as that experienced on average during the first half of the year. Since the beginning of 1973, personal income, seasonally adjusted, has grown at an 8.8 percent annual rate, somewhat slower than the 10.2 percent expansion during 1972. Of the $1.2 billion step-up in transfer payments in July, about one half was attributable to the extension of Medicare coverage to social security beneficiaries under 65 years of age.

Retail sales, seasonally adjusted, spurted by $1.4 billion in July to $42.6 billion. The July increase in sales more

than reversed the $0.5 billion decline registered the previous month and brought the level of retail sales 1.5 percent above the previous peak established this past March. The July resurgence appears to have resulted in part from the pickup in sales of new domestic-type autos. Sales of imported cars remained at an annual rate of 1.8 million units in July, down from the 1.9 million to 2.0 million unit pace of the first five months of 1973. July retail sales of other consumer durables remained below March levels; however, sales of nondurable goods posted an unusually robust increase. No doubt part of this gain reflects recent stockpiling of beef and other foodstuffs. Moreover, if the sales totals are adjusted for price increases, it appears that retail sales volume has risen much more slowly in 1973 than it did during 1972. Indeed, adjusted for price rises, the July volume of retail sales was below the level of March. Since March, the all-commodities consumer price index has climbed at an annual rate of 7.6 percent while current-dollar retail sales have risen at a 4.6 percent rate.

Consumer credit outstanding expanded substantially over the first six months of the year, with the seasonally adjusted June gain of $2.1 billion about equaling earlier monthly average increases. Automobile credit grew moderately in June, but noninstalment credit, which includes retail charge accounts and service station credit cards, swelled by $0.5 billion, the largest increase in six months. Part of this expansion certainly stems from price rises.



Recent evidence suggests that residential construction activity has moderated from the hectic pace of 1972 and early 1973. Housing starts rose in July to a seasonally adjusted annual rate of 2.18 million units. However, taking a somewhat longer perspective, the July pace was slightly slower than the 2.21 million unit annual rate averaged during the second quarter and considerably below the 2.40 million first-quarter rate. Housing starts were at a 2.37 million unit rate in 1972. Newly issued building permits declined in July to a level substantially below that averaged during the first half of the year. Mobile home deliveries slipped in June for the third consecutive month to a seasonally adjusted annual rate of 616,000 units. Similarly, inventories of unsold new one-family homes continued to mount, while the number of homes sold dropped to a seasonally adjusted annual rate of 652,000 units, the slowest sales volume in two years. These movements led to a substantial increase in the inventory-sales ratio; at the end of July, inventories of unsold single-family homes equaled a record 8.3 months of sales, substantially above the 6.2 months of a year earlier. These data suggest that a considerable amount of overbuilding may have occurred.

An additional perspective on the weakening of the demand for housing is evident in the increased amount of time it takes for a new one-family home to be sold from the start of construction. During the second quarter, it took a median of 4.7 months (seasonally adjusted) from groundbreaking to sale. This represents a considerable lengthening from the 3.9 months required during the first quarter and the 3.1 months averaged in 1972. The longest monthly sales span was recorded in 1966 when the "for sale" time reached 6.1 months. Housing activity is not expected to rebound in the near future in light of the decreased availability and increased cost of mortgage funds.

RECENT PRICE DEVELOPMENTS

Recent consumer price movements have been dominated—and their interpretation complicated—by the latest changes in the Economic Stabilization Program. On June 13 the President announced a freeze on virtually all prices, with the major exception of rents and unprocessed agricultural products at the farm level. Wages and interest rates were, however, allowed to change as long as increases were in keeping with the Phase Three guidelines.

For most nonfood items, the freeze ended and Phase Four started on August 12, with prices for these items permitted to rise no faster than the dollar increase in costs, subject to profit margin requirements and notification by large producers.

Changes in food price controls have been somewhat different. Price ceilings had been imposed on beef, lamb, and pork at the end of March and were continued when other food prices were frozen in mid-June. On July 18, food prices, with the exception of beef, were allowed to rise to reflect increases in raw agricultural prices. Beef ceilings remain in effect until September 12, at which time prices of all food items will be allowed to rise by as much as the dollar increases of all costs, subject to profit margin requirements and notification by large producers.

During July, the consumer price index rose at a 2.7 percent annual rate after adjustment for normal seasonal variation. However, since the freeze and subsequent modifications to the controls program have undoubtedly affected the usual seasonal pattern of price changes, it is best to examine both the adjusted and the unadjusted data. At an annual rate, prices of nonfood commodities fell 1.9 percent before seasonal adjustment but rose 1 percent after adjustment, bringing the rise over the past twelve months to 3.4 percent (see Chart III). Prices of services, which are not adjusted for seasonal variation, increased at an annual rate of 2.6 percent in July and 3.7 percent over the past year. Increased rents and home-mortgage interest rates, which are items exempt from controls, contributed to the rise in services prices during the month.

Although food price data were gathered largely during the period when the freeze was in effect, such prices rose at a 6 percent annual rate on a seasonally adjusted basis and even more rapidly on an unadjusted basis in July. Over the past six months, food prices have soared at a 17.1 percent seasonally adjusted annual rate. An undetermined portion of the July increase in the price of food may have resulted from technical factors associated with the timing of data collection and the definition of ceiling prices used for the freeze. Nonetheless, the magnitude of the July rise is somewhat surprising.

Food price data collected for the August consumer price index will largely, but not entirely, reflect the first stage of the food price rules that went into effect on July 18. While there have been wide fluctuations in the prices of some food items since that time, it seems likely that further increases in food prices will occur in the months ahead as a result of sustained demand pressures.

The Business Situation

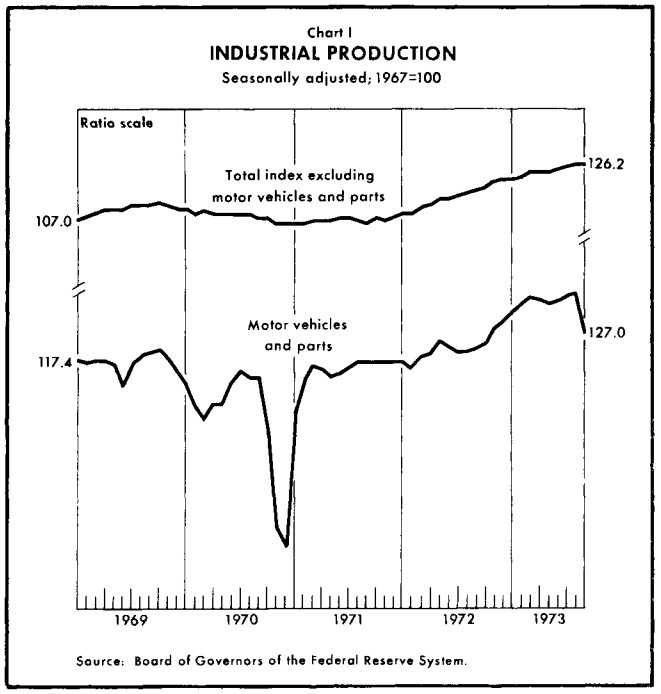
Recent developments suggest that economic expansion continues to be constrained by shortages and capacity limitations arising under the pressures of strong aggregate demand. Industrial production declined in August because of a sharp drop in the output of automobiles and trucks, in part resulting from materials shortages. With backlogs of unfilled orders still rising rapidly and the inventory-sales ratio for manufacturing continuing low, it is apparent that demand is straining productive capabilities. The latest Government survey indicates that businesses now anticipate even larger increases in expenditures on plant and equipment for the final quarters of 1973 than were previously reported. Retail sales remained high in August, as rapid increases in personal income helped to bolster consumer demand. Some buying, however, seemed to be related to attempts to beat expected post-freeze price increases. Only the housing sector has shown clear signs that a considerable slackening in activity is under way. While the unemployment rate held steady in September, the high level of job vacancies and increasing complaints that certain types of labor are in short supply suggest a tight labor market.

Soaring inflation in recent months has been marked by especially rapid increases in food prices. In August, the consumer price index rose at its most rapid rate in over twenty-five years, with food prices exploding at a 74 percent annual rate. At the wholesale level, prices dropped in September, as sharp declines in the prices of certain agricultural commodities led to a drop in the overall index at an 18.3 percent seasonally adjusted annual rate. Nevertheless, over the three months ended in September, wholesale prices rose at a 12.6 percent annual rate because of the overwhelming increase in prices of farm products, processed foods, and feeds. There are also indications that wholesale industrial prices have begun to rise rapidly again, especially in areas where demand is pressing strongly against capacity. At this point, the effects of rapidly rising wholesale food and other prices in earlier months are probably not fully reflected at the retail level. Moreover, while wage increases appear modest by comparison with the acceleration in prices, there are some tentative signs that the size of wage changes may be picking up.

PRODUCTION, ORDERS, AND INVENTORIES

During August, the Federal Reserve Board's index of industrial production edged down at a seasonally adjusted annual rate of 2.8 percent, registering its first decline since October 1971. This downturn was primarily the result of a substantial fall in the output of motor vehicles and parts. Such production, which accounts for about 5 percent of the total index, dropped 12 percent in August, the sharpest one-month decline since the 1970 automobile strike (see Chart I). Originally scheduled to exceed 10 million units at an annual rate, actual August output of domestic-type autos turned out to be at a much slower 8 million unit rate. The shortfall reflected the simultaneous occurrence of several unusual developments. Intensely hot weather covered much of the United States during portions of the month and hampered production by prompting scattered layoffs and plant shutdowns. The Canadian rail strike had an adverse impact on the output of domestic-type passenger cars, since there is a substantial amount of integration of auto production facilities between the United States and Canada. However, the major portion of the August setback resulted from shortages of a wide variety of automotive parts. Although production was proceeding at a brisk clip in early September, the seven-day strike at Chrysler held total September output to a 9 million unit annual rate, compared with rates of production averaging around 10 million units during the first half of 1973.

Excluding motor vehicles and parts, industrial production advanced at a 5.7 percent seasonally adjusted annual rate in August. Over the past six months, nonautomotive industrial production has advanced much more slowly

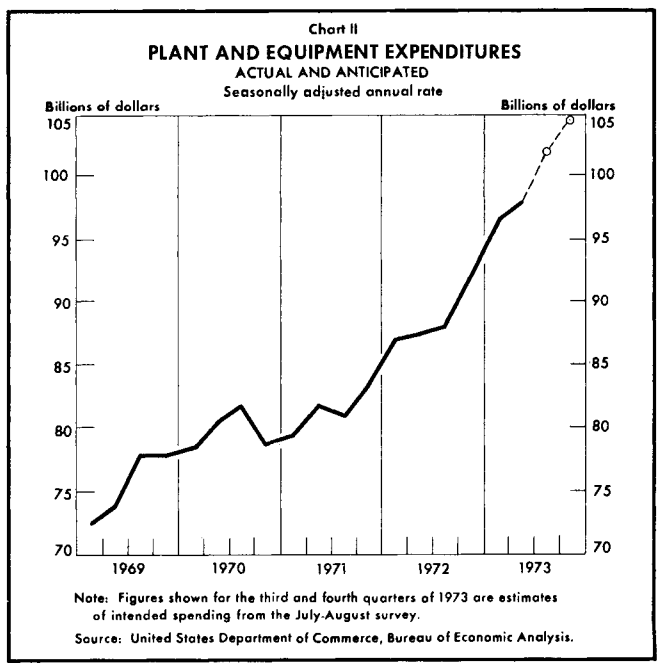


than during the previous half year. Some of this moderation probably represents the impact of capacity constraints and supply bottlenecks in many important sectors of the economy. In any event, output of intermediate products rose sharply in August and output of business equipment increased modestly despite a decline in truck production.

Firms are planning to increase their plant and equipment spending in 1973 by 13.2 percent according to the Commerce Department survey taken during July and August (see Chart II). This was the same increase as reported in the April-May survey. Since actual outlays fell more than $1½ billion short of anticipated levels in the second quarter—at least partly as a result of supply problems—the most recent findings imply a substantial step-up in spending during the second half of this year. The April-May survey projected a 10 percent annual rate of growth over the last two quarters but the more recent estimates envision a 14 percent climb. If realized, the 13.2 percent rise in plant and equipment spending would make this the largest increase since 1966, when outlays surged 16.7 percent. Spending in nonmanufacturing industries is slated to rise by 9.9 percent, compared with the rapid 19.4 percent increase expected for manufacturing. A number of the industries that are facing capacity constraints, such as primary metals, textiles, and paper, have revised their plant and equipment spending plans upward.

Orders placed with manufacturers of durable goods fell by $0.4 billion (seasonally adjusted) in August, marking the second consecutive monthly decline. In July the cutback was centered in orders for defense goods, but bookings for these products rebounded substantially in August. A sizable increase in bookings for primary metals helped offset declines in other areas. Most of the August slowing in new orders occurred in nondefense capital goods industries, where bookings were unchanged from June to July. Over the first six months of 1973, orders for capital goods increased rapidly, however. The backlog for nondefense capital goods rose considerably in August and accounted for over 25 percent of the large advance in unfilled orders. More than 30 percent of the total existing backlog is centered in the primary metals industries where supply problems have persisted, nearly doubling the backlog during 1973. In August, shipments of durable goods declined following a rather large July increase, so that the ratio of unfilled orders to shipments increased to a new 1973 high of 2.61 months.

An indicator of broader coverage, the book value of seasonally adjusted business inventories, including all manufacturing and trade, increased $1.4 billion in July. In comparison, the average monthly increment in total business inventories was $1.9 billion over the first half



of 1973. The magnitude of these changes has been affected, of course, by the sharp intensification of inflation over the past seven months, and it appears that the physical volume of inventories has increased little. For example, during the first half of this year, the monthly book value increase in business inventories was well above the $1.2 billion increase averaged in the second half of 1972. However, the physical or real increase in inventories for the first half of 1973, as recorded in the national income accounts, was about half that of the earlier period. Another aspect of the current inventory situation which stands out is the persistently low level of the inventory-sales ratio by historic standards. Business sales advanced strongly during July, and the ratio of inventory to sales fell to 1.410, the lowest level since the early days of the Korean war.

Preliminary data indicate that manufacturing inventories rose by nearly $1 billion in August, a slightly larger increase than those registered on average over the first seven months of the year. At the same time, manufacturers' shipments dropped, in part because of the problems that plagued automobile producers in August, so that the inventory-sales ratio for manufacturing increased modestly.

CONSUMER SPENDING AND RESIDENTIAL CONSTRUCTION

Consumer spending has remained strong in recent months, with demand fueled in part by relatively large increases in personal income. Personal income rose $8.5 billion in July and $10.6 billion in August after registering average monthly gains of just over $7 billion during the first half of the year. While wage and salary disbursements have continued to advance strongly, farm proprietors' income increased by an unusual $0.8 billion in both July and August because of higher farm prices. In addition, transfer payments spurted in August in part through a cost-of-living adjustment applied to pensions of retired Federal civilian employees.

Retail sales rose by a very sharp 3.7 percent in July to $42.7 billion, following a decline between March and June, and remained at the high July level in August according to the advance report. In perspective, retail sales during August were 3.2 percent above the average of the second quarter, which had in turn shown virtually no increase from the January-March average. In August, sales of nondurable goods remained at the high July pace. Recent strong demand for home food freezers, undoubtedly connected with food stockpiling, has helped to boost sales in the furniture and appliances category which spurted sharply upward in August. Sales of new domestic-type autos slowed to a 9.7 million unit annual rate in August but rebounded to a very strong 10.6 million unit rate in September. Over the first nine months of the year, sales of domestic cars have been at a 10.1 million unit pace. The strong September pickup in sales is of note in view of the fact that dealer inventories were quite low, according to industry observers, with supplies of the popular small models especially tight. Sales of imported autos moderated to 1.7 million units (seasonally adjusted annual rate) in August and 1.5 million units in September, down from the previous two months and well under the historic high of 2 million units attained during February and March of this year.

Retail purchases have been facilitated, in part, by continued sizable expansion in consumer credit. In August, consumer credit outstanding rose by $2 billion, somewhat less than advances averaged over the first seven months of the year but still substantially above the average monthly increases of 1972. Increases in nonautomotive instalment credit and in automobile paper have been large in recent months, while the growth of noninstalment credit has moderated relative to its performance earlier this year.

The pace of housing activity continues to slacken. Housing starts dipped to 2 million units at a seasonally adjusted annual rate in August, off sharply from the historic peak of 2.5 million units achieved this past January. The August decline, which reduced starts to their slowest pace in almost two years, was concentrated primarily in single-family units. Newly issued building permits fell in August to an annual rate of 1.7 million, well below the December 1972 peak of 2.4 million. This marked the seventh decline in new building permits issued in the past eight months. Sales of mobile homes, which had been a rapidly growing component of the housing stock, have fallen for four consecutive months with seasonally adjusted July shipments of 569,000 at an annual rate, the lowest since last October. July sales of new one-family homes dropped well below the June pace, while inventories of unsold singe-family homes rose sharply to a record 8.8 months of sales.

All of these data were gathered before the Administration's mid-September announcements of proposed changes in national housing and home financing programs. Some of these proposals, such as lifting the interest rate ceilings on Federal Housing Administration (FHA) mortgages and instituting a tax credit for financial institutions on mortgage lending, require Congressional approval and thus are not likely to have an impact on housing in the very near term. However, the two major initiatives which can be implemented without further legislation—the expansion of the Government National Mortgage Associ-

ation's capacity to purchase FHA-insured mortgages and the establishment of a $2½ billion program of forward commitments to savings and loan associations by the Federal Home Loan Bank Board—might help bolster housing activity in the future.

PRICES AND WAGES

The economy continues to feel the effects of the price advances originating in the agricultural sector. Consumer prices rose at a seasonally adjusted annual rate of 23.1 percent in August, the fastest increase in more than twenty-five years. Over the year ended in August, the consumer price index jumped 7.5 percent. This is much faster than the most rapid twelve-month increase recorded during the late 1960's and early 1970's—the rise of 6.4 percent over the year ended in February 1970. The index for food consumed at home exploded at a 92 percent annual pace in August, lifting such prices to a level 23.3 percent above that of a year earlier. Increases registered for poultry, eggs, and pork contributed substantially to the August advance. Even prices of fresh fruits and vegetables, items now in season, rose considerably on a seasonally adjusted basis, although they declined on an unadjusted basis.

A substantial rise in consumer food prices had been widely anticipated in light of previously announced increases at the wholesale level, but the August behavior of prices of nonfood consumer items, while less dramatic, is probably more surprising and complicated to assess. Nonfood commodity prices increased at a rapid 5.8 percent annual rate on a seasonally adjusted basis but only a 2.9 percent annual rate before seasonal adjustment. In view of the many changes in the Economic Stabilization Program over the past two years, it is possible that some usual seasonal patterns have been disturbed so that the unadjusted data should also be closely watched. Prices of services, which the Department of Labor does not adjust for seasonal fluctuation, rose at a rapid 7.8 percent annual rate in August, the sharpest advance since April 1970. An increase in mortgage interest costs accounted for a substantial portion of the upswing. Nevertheless, prices of other services, such as rents, medical costs, and telephone charges, also contributed to the increase in this measure.

Extraordinary variations in the wholesale price index have resulted over the past several months in part in response to changes in the controls program. Following a decline of about 17 percent in July, wholesale prices skyrocketed in August at a record 75 percent annual rate and then plummeted 18 percent in September, the largest annual rate of decline for any month since March 1946.

The amazing August increase was propelled by the more than 200 percent (annual rate) rise in wholesale prices of farm products, processed foods, and feeds. Declines in prices of major foodstuffs such as grains and livestock caused the September index to reverse direction and plunge at a record 62 percent annual rate. While the September decline may ease the severity of some price advances faced by the consumer, substantial retail food price pressures undoubtedly still exist. Despite the declines in July and September, prices of farm products, processed foods, and feeds have climbed at an annual rate of 32 percent since June to a level almost 40 percent higher than a year ago.

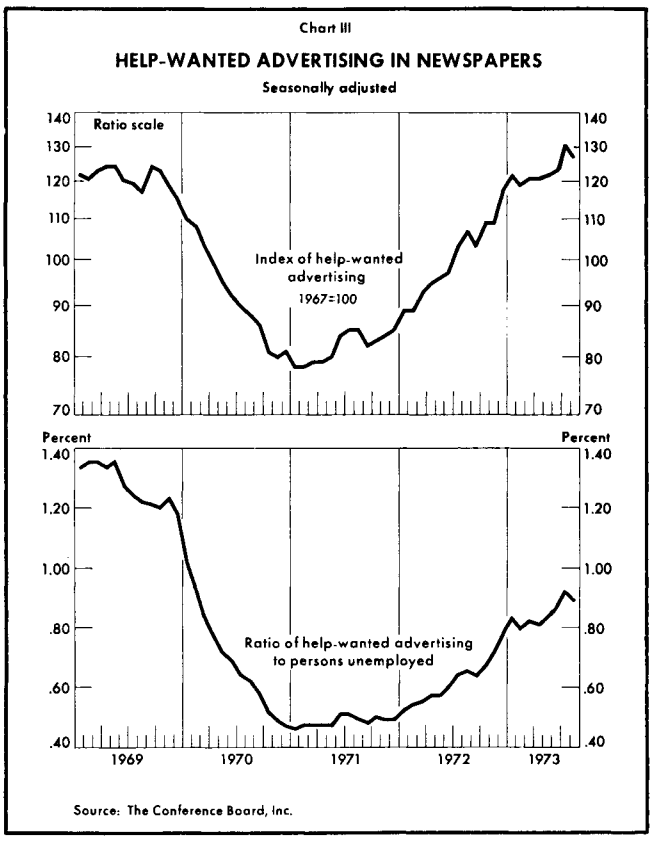
Wholesale industrial prices were essentially unchanged in July as a result of the freeze. They then rose at a 4.7 percent seasonally adjusted annual rate in August, and this was followed by a 7.9 percent jump in September. (Data unadjusted for seasonal variation show much the same pattern.) September's large advance brought the rise over the past year to nearly 8 percent. The hike in wholesale industrial prices in both August and September reflected increases in prices of metals, textiles, and lumber and wood products—industries in which supply constraints have been reported.

Wages have shown a comparatively modest response to the protracted acceleration in consumer price changes. However, there are some tentative signs that the size of wage increases is beginning to pick up. The index of average hourly earnings for private nonfarm workers is probably the closest approximation to basic wage rates available because it eliminates the effects of interindustry employment shifts and manufacturing overtime hours. Although the index is very volatile on a month-to-month basis, an examination of changes over the most recent six months shows that hourly earnings have increased at an annual rate of 7.4 percent, compared with a slower rise of 5.7 percent during the previous half year.

LABOR MARKET DEVELOPMENTS

Conditions in the labor market remain basically strong although, as is often the case with monthly statistics, some of the most recent evidence has been mixed. According to the survey of households, the civilian labor force and employment registered very large increases in September on a seasonally adjusted basis after contracting slightly in both July and August. Because data based on samples—even one as large as the household survey which encompasses some 50,000 households—can move somewhat erratically on a month-to-month basis, comparisons over longer time spans often help to give a clearer picture

of the underlying situation. Over the year ended in September, the civilian labor force expanded by a very rapid 2.7 percent, while the total civilian population of working age increased by a considerably smaller 1.8 percent. The overall unemployment rate edged up from 4.7 percent in July to 4.8 percent in August, and this rate was maintained in September. However, the decline in the unemployment rate from the 5.5 percent level prevailing a year ago in the face of very rapid labor-force growth is significant both from the narrow technical standpoint and from the broader vantage point of assessing underlying economic developments.



The separate survey of establishments revealed that the number of persons on nonagricultural payrolls rose by about 200,000 workers in both August and September following a small decline in July. This brought the advance over the past year to 2.6 million jobs. During the third quarter, employment growth in the major industries was particularly strong in services. Manufacturing employment, however, was essentially unchanged over the quarter after having increased by more than 900,000 over the preceding twelve months.

According to the Labor Department, the number of seasonally adjusted unfilled job vacancies in manufacturing was 191,000 in August, up sharply from 170,000 at the start of this year and 131,000 a year ago. This is consistent with reports of shortages of certain types of skilled labor developing in recent months. Over the past year the number of long-term job vacancies—those which have gone unfilled for a month or more—has risen 64 percent, compared with the 39 percent increase in shorter term vacancies over the same period. The Conference Board's index of the volume of newspaper help-wanted advertising is the closest available approximation to an all-industry gauge of job vacancies. In July the index jumped to a record 131 percent of the 1967 base and, while it slipped to 127 in August, it remained well above rates posted earlier in 1973 or in previous years (see Chart III). The ratio of this index to the number of unemployed persons, also indexed on a 1967 base, may be more suitable for comparisons spanning several or more years as it adjusts for labor-force growth. Since its trough in the first half of 1971, this ratio has risen rather steadily. Although the August ratio fell off somewhat from its July peak, it is higher than it has been in recent years but substantially below levels reached in the late 1960's.

The Business Situation

The economy is continuing to expand at a more moderate rate than was experienced during the period of hectic and unsustainably rapid advance in late 1972 and early 1973. Over the past two quarters, the growth of real gross national product (GNP) has averaged 3 percent at an annual rate. This is well below the 7 percent averaged from the end of 1971 through the first quarter of this year. At this point, however, it is still unclear how much of this slowing in real growth is the consequence of capacity constraints and supply bottlenecks and how much is the reflection of less exuberant demand. At present, there are many signs that pressures on capacity are very pronounced. Shortages of parts and other production difficulties helped keep new car output and sales somewhat below what they might have been in the third quarter. The recent decline in new orders for durable goods may reflect the fact that some major industries are booked to capacity. Delivery lead times for new orders are exceedingly long, and the rate of capacity utilization in the major materials industries climbed to a record in the third quarter. By October, unemployment had fallen to its lowest rate in three and one-half years.

Residential construction is one area where activity has slackened. Consumer demand may also be moderating, and there has been a sharp deterioration in "consumer confidence". The threatening energy crisis has added another element of uncertainty to the economic outlook and was responsible in part for the gloom which pervaded the stock market in early November. On the other hand, business spending on plant and equipment has been very strong and, according to the available surveys of investment intentions, should remain strong in 1974.

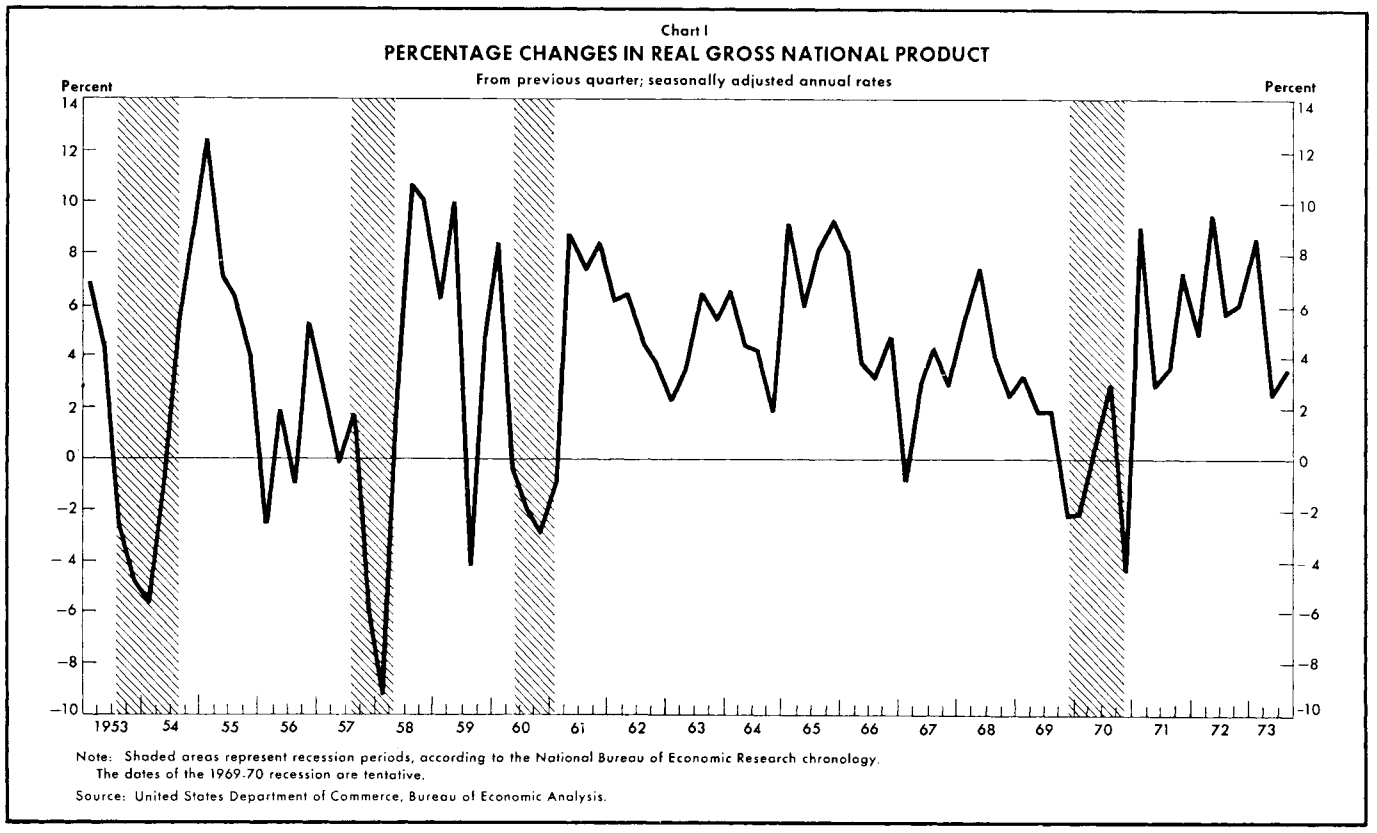
While interpretation of the price data has been complicated by the frequent changes in the Economic Stabilization Program, inflation clearly remains very much a problem. The GNP deflator increased at a 6.7 percent annual rate in the third quarter, about the same as over the first half of the year but about twice as fast as during 1971 and 1972. Consumer price increases moderated in September, but this slowing came on the heels of a spectacular burst in the preceding month. Total consumer prices rose at a 10 percent annual rate over the three months ended in September and 7.4 percent during the past year. Although the degree of acceleration has been less dramatic, wages are also rising rapidly. Hourly compensation in the private economy climbed at an 8.4 percent annual rate in the latest quarter and, along with slower growth in productivity, led to a substantial increase in unit labor costs.

GROSS NATIONAL PRODUCT AND RELATED DEVELOPMENTS

According to preliminary estimates from the Department of Commerce, the market value of the nation's output of goods and services (GNP) rose $32 billion to a seasonally adjusted annual rate of $1,304 billion during the third quarter of 1973. Measured in current dollars, GNP climbed at a 10.4 percent annual rate, somewhat above the pace recorded in the second quarter. After adjustment for changes in the price level, GNP expanded at a 3.6 percent rate in the July-September period, up from the second-quarter increase but well below the rate of expansion experienced from late 1971 through the first quarter of this year.

The recent slowing in the growth of real GNP may represent a return to more sustainable rates of increase and does not necessarily presage the end of the expansion and the onset of a recession. In the past, real growth has on several occasions dropped below its long-term trend of close to 4 percent in successive quarters without being followed by a recession (see Chart I). Moreover, continued high levels of unfilled orders with respect to sales volume, of capacity utilization, and of employment suggest that supply constraints are responsible, at least in part, for the moderation in growth.

The relative contribution of expenditure components to the third-quarter GNP gain differed perceptibly from the pattern of the April-June period (see Chart II). Inventory investment, which did not contribute to GNP expansion in the previous quarter, added $4.2 billion to the third-quarter advance in GNP, while final expenditures—GNP net of inventory accumulation—rose by $1.9 billion less than in the April-June period. Inventory accumulation reached $8.7 billion at an annual rate in the third quarter,



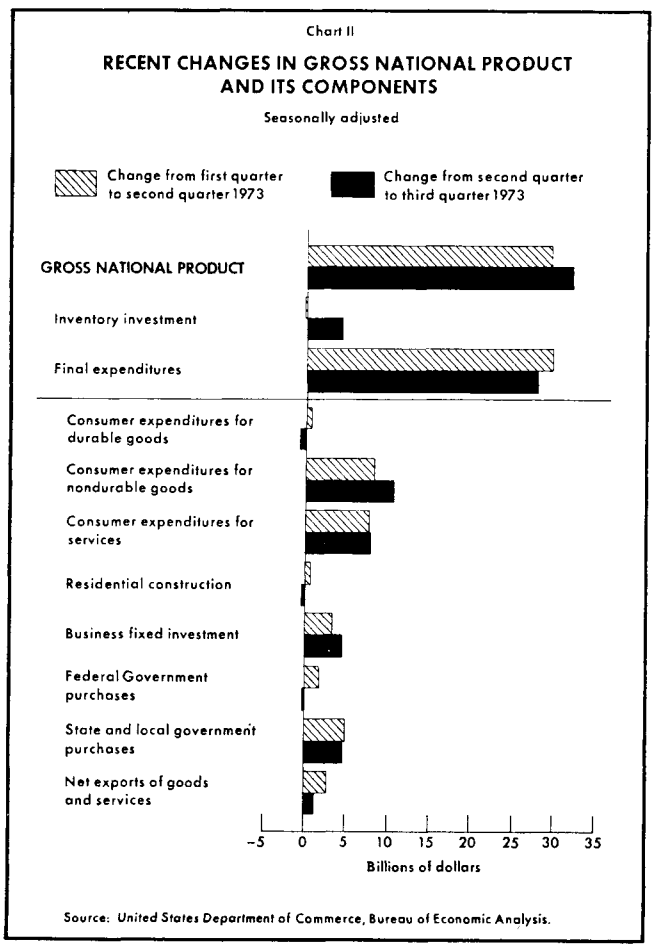
its highest level since the corresponding quarter of 1972 and almost twice the size of the gains registered in the first two quarters of this year. Notwithstanding this rise in inventory spending, by historical standards the ratio of inventories to sales for all business remained low in August, the latest month for which data are available, suggesting that further strengthening in this area is likely in the quarters ahead. A significant proportion of the third-quarter inventory buildup ($1.5 billion) was in the farm sector, with farmers apparently holding supplies off the market in anticipation of higher prices.

The growth of personal consumption expenditures has slowed substantially. Over the past two quarters, the average increase has amounted to $17 billion, compared with an average rise of $20 billion per quarter over the year ended this past March. When stripped of price increases, the braking emerges more clearly, since consumption expenditures grew at only a 1½ percent annual rate during the six months ended in September, after rising 8 percent in the previous four quarters.

During the third quarter, current dollar spending on consumer durables declined $0.7 billion, marking the first cutback in almost three years. Mobile home sales, which are included in consumer outlays for durable goods, accounted for much of the decline. Expenditures for passenger cars edged down $0.2 billion, after declining $0.5 billion in the previous quarter. While this decrease may reflect a change in the composition of demand toward smaller vehicles, it is probably also related to the difficulties experienced by domestic and foreign producers in supplying adequate numbers of vehicles. Sales of domestically produced cars dropped to a seasonally adjusted annual rate of 8.7 million units in October, down from the 10.1 million units averaged over the earlier months of 1973. Industry observers are unsure how much of this decline represents a weakening of demand. It is also worth noting that purchases of nonautomotive durable goods were essentially unchanged during the quarter. With sharply higher outlays for food and beverages, spending on nondurables picked up somewhat, but in real terms the annual rate of increase was little more than half the rise experienced during the four quarters ended this past

March. Expenditures for services, however, rose by a very rapid $7.9 billion, which in current dollar terms is the largest rise on record, and after adjustment for price increases represents the largest expansion since the first quarter of 1972.

The overall slowdown in the growth of consumer spending seems related to a number of developments. Shortages, particularly for automobiles, probably meant that some demands went unfilled during the third quarter. On the other hand, some weakening of consumer demand appears to have taken place during the past half year. In nominal terms, disposable personal income increased almost as briskly in the past two quarters as during the previous year, but inflation pared the second- and third-quarter real gain to an annual rate of 2 percent, which is less than a third as large as the rise over the year ended in March. As measured by the University of Michigan index, consumer optimism deteriorated sharply during the third quarter and reached a record low. This rather precipitous decline is related, in part, to apprehensions concerning inflation.

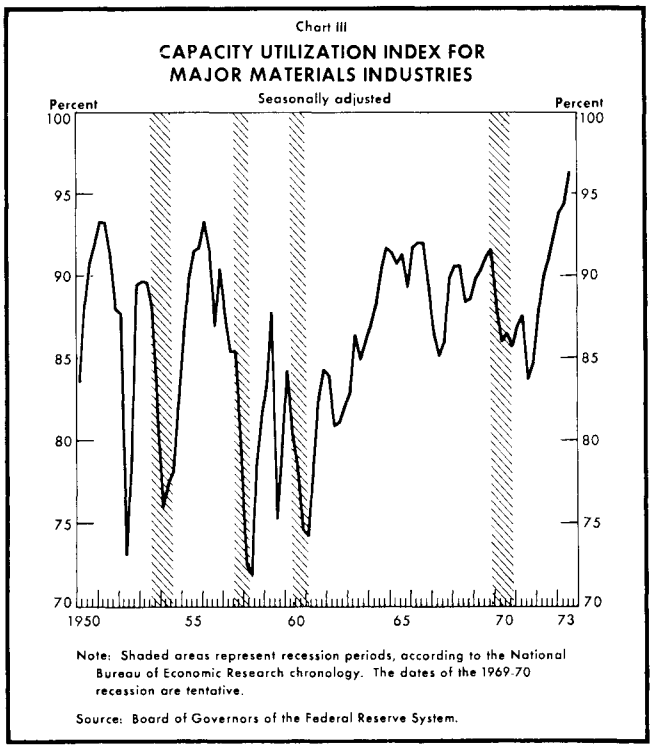


Business fixed investment climbed by $4.6 billion in the July-September period, a greater rise than that of the second quarter but less than the expansion of the two preceding quarters. Spending on structures increased by $2.8 billion, the largest advance on record. At the same time, durable equipment expenditures rose $1.9 billion. Equipment outlays would probably have been higher, but the output of automotive equipment—such as trucks—was hampered by parts shortages and other production problems during the quarter. Over the first three quarters of this year, business fixed investment rose at a 15.7 percent seasonally adjusted annual rate, compared with the 15.1 percent rise recorded in 1972.

The sizable backlog of unfilled orders and the high level of capacity utilization in the economy suggest a need for continued expansion in capacity. Basic materials industries, in particular, are operating very close to capacity levels. According to the Federal Reserve Board, the major materials producing industries—which include such key areas as primary metals, paper, petroleum refining, and textiles—were operating at a record 96.3 percent of their estimated capacity during the third quarter (see Chart III). In perspective, current operating rates in the materials industries substantially exceed those experienced during previous periods when capacity pressures were quite pronounced, e.g., during the Korean war, the mid-1950's, and the late 1960's. Recent survey data indicate substantial demand for fixed investment goods in the coming year. The latest Lionel D. Edie & Company Inc. survey of intended plant and equipment spending in 1974 points to a 12 percent increase above the 1973 level, while the Rinfret-Boston fall survey foresees a 15.3 percent advance.

Residential construction spending fell by $0.3 billion in the third quarter, the first decline since the second quarter of 1970. Other measures of housing activity confirm the slack in home building. Over the third quarter, housing starts dropped by 17.2 percent to 1.76 million units (annual rate) in September. This figure is 27 percent below the rate of starts posted a year earlier. Similarly, building permits skidded 21 percent in the third quarter to a seasonally adjusted annual rate of 1.6 million in September. Moreover, the ratio of unsold new homes to monthly sales of new one-family homes increased in August, the latest month for which data are available, to an all-time high of 10.1 months of sales at the August rate.

Government purchases of goods and services rose at a $4.6 billion rate, the slowest pace in the past four quar-



ters. Spending at the state and local levels rose $4.8 billion, down somewhat from the $5.1 billion gain averaged in the preceding year. The fall in outlays at the Federal level was accounted for by a decrease in defense spending.

PRICE DEVELOPMENTS

There was little indication of a significant cooling of inflation in the third quarter. However, because of changes in the Economic Stabilization Program introduced during the period, it is difficult to separate the transitory from the more fundamental phenomena. The period began with a freeze in effect on prices of almost all items. This was lifted for most foods on July 18, for most nonfood items on August 12, and for beef on September 10. Subject to the profit margin and notification requirements, current Phase Four guidelines allow prices to go up only as fast as the dollar increases in costs. Throughout the quarter, wages were permitted to rise in accord with the ground rules developed earlier under Phases Two and Three.

According to preliminary data, the implicit GNP price deflator rose at a 6.7 percent annual rate in the third quarter, the same as its increase over the first half of the year. The severity of the acceleration in the rate of inflation can be seen from the fact that during both 1971 and 1972 the GNP deflator rose only about 3½ percent. Agricultural prices continued to have a marked impact on the overall inflation rate during the third quarter. The deflator for GNP originating in the farm sector rose at the astronomical annual rate of 107 percent, faster even than the 51 percent and 76 percent climbs recorded, respectively, during the first two quarters of the year. In the private nonfarm business sector, prices increased at a 4.3 percent rate. While this advance appears quite modest alongside the farm deflator, it is little changed from the 4.8 percent rise recorded over the first half of the year and, perhaps even more disturbing, is well above the 2½ percent averaged during each of the two preceding years.

Consumer prices rose at a 3.8 percent seasonally adjusted annual rate in September, down considerably from the very rapid August pace of about 23 percent. Food prices, which soared at almost a 74 percent annual rate in August, declined 1.6 percent in September and were largely responsible for this slowing. Given the timing distortions introduced by the price freeze and Phase Four, a look at a somewhat longer time span than a single month is useful. During the third quarter, total consumer prices moved up at an annual rate of 10 percent, compared with an advance of nearly 8 percent over the first half of the year. Food prices increased at a 26 percent pace during the quarter, somewhat more rapidly than over the first half of the year.

In the three months ended in September, seasonally adjusted prices of consumer nonfood commodities rose 2.6 percent at an annual rate, more slowly than the 4.6 percent rate of advance in the first half of the year. During September, such prices increased by a mere 1 percent after rising almost 6 percent in the previous month. However, since the Economic Stabilization Program may have affected normal seasonal patterns, it is worth noting that, unadjusted for seasonal variation, nonfood commodities prices rose at a 4.8 percent annual rate in September, up from 2.9 percent the month before and from the 1.9 percent decline recorded in July under the influence of the freeze. Increases in the price of services, which are not adjusted for seasonal variation, accelerated sharply to about a 7 percent annual rate in the third quarter from a 4 percent rise in the first half of the year and 3½ percent in 1972. While a major source of rising services prices in recent months has been higher home-mortgage interest costs, prices of other items have also increased rapidly.

Wholesale prices fell in October for the second consecutive month. The decline, at a 3.6 percent seasonally adjusted annual rate, stemmed from a sharp drop in agricultural prices which more than offset a substantial in-

crease in prices of industrial commodities. Prices of farm products, processed foods, and feeds fell nearly 40 percent at an annual rate in October. Nonetheless, wholesale farm prices still stand 28 percent higher than six months ago and 35 percent above the level of a year earlier. During October, prices of industrial commodities jumped 13.7 percent (annual rate), the largest monthly gain since May. Some of this advance may be attributed to a bunching of price increases, since under Phase Four rules large firms could not raise prices until mid-September. In any event, a sizable proportion of the overall advance in industrial commodities prices was accounted for by rising fuel prices, and prices of textile products and apparel, steel and iron, and nonferrous metals also rose rapidly. Over the year ended in October, wholesale prices of industrial commodities climbed 9.1 percent, up substantially from the 3.3 percent increase of the previous year.

WAGES, PRODUCTIVITY, AND EMPLOYMENT

Recent data indicate that the pace of wage increases has undergone a noticeable acceleration. In the third quarter, compensation per hour of work in the private economy rose at a seasonally adjusted annual rate of 8.4 percent, bringing the rise over the past year to 8 percent. In comparison, compensation climbed 6.2 percent over the year ended in the third quarter of 1972. However, after adjusting for the very rapid climb in the consumer price index, real private compensation declined in both the second and third quarters. The evidence that wages have not kept up with inflation during much of 1973 points to increased pressures on wage levels as workers try to maintain living standards.

According to data gathered by the Labor Department on major collective bargaining settlements, contracts negotiated during the first nine months of the year called, on average, for first-year wage rate increases of 6 percent and life-of-contract gains of 5.5 percent. However, first-year increases for wages and benefits combined came to a substantially larger 7.6 percent. Because these Labor Department data do not include those payments made under "escalator clause" provisions contingent on movements in the consumer price index, they understate the growth of compensation that will eventually emerge under many of these contracts. At present, about 40 percent of the more than ten million workers under major collective bargaining agreements (those covering 1,000 or more workers) have cost-of-living escalator clauses in their contracts.

Productivity, as measured by output per hour of work in the private economy, rose at an annual rate of 1.4 percent in the most recent quarter, following a small decline of 0.3 percent in the April-June period. In comparison, productivity increased more than 5 percent over the year ended this past March and at an annual rate of close to 3 percent during the past two decades. In the short run, productivity growth typically surges during the early stages of a cyclical recovery, as it did starting in 1972 and continuing through early 1973, and then begins to taper off. During the first three quarters of 1973, manufacturing productivity rose at a fairly rapid 4.8 percent annual rate, but even this increase represents a marked deceleration from the 7.3 percent advance in 1972. The recent slowing has undoubtedly been influenced by the fact that important sectors of the economy are pressing against capacity, making further output increases difficult to obtain. As a consequence of the combined changes in hourly compensation and productivity, private sector unit labor costs climbed 6.6 percent (annual rate) in the third quarter, after soaring 7.7 percent in the previous period. Over the year ended in the first quarter, unit labor costs increased by 2.1 percent. Given the near-term outlook for relatively slow productivity growth, only a considerable reduction in the rate of compensation increase could bring about a substantial lessening in the pressures on prices arising from labor costs.

Overall, the data gathered in October indicate continued firm labor market conditions. According to the household survey, seasonally adjusted employment jumped by a very large 570,000 persons, following an even bigger September climb. On a month-to-month basis, the household survey tends to give somewhat volatile readings of employment and labor force changes. Monthly increases during the past half year, however, have averaged a very substantial 300,000. The growth of the labor force in October, while strong, was smaller than that of employment. Thus, the unemployment rate, which had been essentially unchanged at 4.8 percent since June, fell to 4.5 percent in October, its lowest level in three and one-half years.

In the separate October survey of nonfarm establishments, seasonally adjusted employment also registered a large gain. Contributing strongly to the overall advance of 300,000 was the 100,000 rise in manufacturing employment, which had shown very little change between June and September. Over the past half year, manufacturing employment has, on average, increased by 40,000 per month, less than half as fast as in the preceding six months. Although October employment was up, both the average workweek and overtime hours for manufacturing production workers retreated toward their August levels and were well below the peaks reached earlier this year.

The Business Situation

Economic activity has continued to expand, but at a slower pace than that of 1972 and early 1973.* However, the ability of the economy to maintain upward momentum has come to depend to an uncertain degree upon the magnitude and economic impact of the energy shortage. The size of the prospective shortage, severely exacerbated by the Mideast oil embargo, has been subject to widely divergent estimates based on different assumptions about the availability of alternative petroleum supplies, the substitution possibilities among existing energy sources, and the severity of winter weather. Moreover, the economic consequences of whatever shortfall in energy supplies materializes have proved difficult to ascertain because of uncertainty both as to just how the overall shortfall will impact on the various economic sectors and regions and as to how productive capacity will be affected by the pattern of reductions that does emerge. As a result, quantitative estimates of possible economic repercussions have differed greatly.

The effects of the oil embargo have yet to be widely registered in available economic data because petroleum deliveries from the Mideast had not come to a halt at the time when most of the information was gathered. During October, industrial production and new orders for durable goods increased substantially. However, residential construction continued to contract, and business inventory accumulation remains surprisingly weak when the impact of rapidly rising prices is stripped away. Retail sales remained essentially unchanged in November, continuing the erratic and relatively slow growth over the past eight months. The energy problem has weighed heavily on the stock market, where prices have fallen precipitously since the beginning of November. Moreover, planned automobile production has been reduced because of the drop in sales, related at least in part to concern over the availability and cost of fuel.

The pervasive role of petroleum products in overall industrial production implies that fuel price increases may intensify the strong inflationary pressures already in prospect for the months ahead. The consumer price index rose at a very rapid annual rate of close to 10 percent in October. Wholesale prices for November are among the first of the economic barometers to be affected by the oil embargo. Propelled by rising fuel costs, wholesale prices jumped at a 21 percent annual rate despite another drop in farm prices. Unemployment was 4.7 percent in November, up from the October rate of 4.5 percent but about the same as the average of the past few months. Given the timing of the data collection, the November labor market statistics were not affected by the shortage of oil.

PERSONAL INCOME, CONSUMER DEMAND, AND RESIDENTIAL CONSTRUCTION

Personal income climbed $9.2 billion in October to a seasonally adjusted annual rate of $1,067.7 billion, following an even more substantial rise the previous month. All of the major categories of personal income increased in October, with the exception of farm proprietors' income; nevertheless, farm income soared 36 percent over the year ended in October. The pay raise for Federal civilian and military employees, which the President sought unsuccessfully to delay until December, amounted to about $1½ billion of the October increase in personal income. Over the first ten months of 1973, personal income has advanced at an annual rate of 10.3 percent, about the same rate of expansion as that experienced in 1972. Of course, accelerating inflation has considerably slowed the gain in real income this year. The consumer price index has climbed at nearly a 9 percent annual rate over the first ten months of 1973, up sharply from the 3.4 percent increase of 1972.

According to the preliminary estimate, retail sales flat-

* The estimate of third-quarter gross national product (GNP) growth has been revised upward slightly from $32 billion to $32.5 billion. Real GNP is now estimated to have grown at a 3.4 percent annual rate, a bit below the preliminary estimate. The annual rate of increase in the GNP price deflator was raised slightly to 7 percent. The estimate of inventory investment was reduced by $4 billion, while the estimate of net exports of goods and services was raised by $3.6 billion to $7.6 billion. Although preliminary estimates of pretax corporate profits rose slightly, after-tax profits fell by $100 million to a seasonally adjusted annual rate of $71.5 billion in the third quarter.

tened out in November when a modest increase in nondurables was offset by a small decline in spending at durables stores. Over the past eight months, retail sales have risen at a slow annual rate of 4 percent, compared with the very rapid rise of 19 percent in the preceding eight months. The slowdown is even more pronounced if allowance is made for a more rapid rate of inflation in the recent period. Not only has the overall growth of retail sales slowed, but the composition has changed dramatically. Although rising more slowly than before, nondurables have provided most of the momentum. Since March, sales volume at automotive outlets has declined at about a 7 percent annual rate, after rising at a 28 percent annual rate in the previous eight months. During the more recent period, nonautomotive durables have edged up at a 2 percent annual rate, only a fraction of the 23 percent climb recorded over the eight months ended this past March.

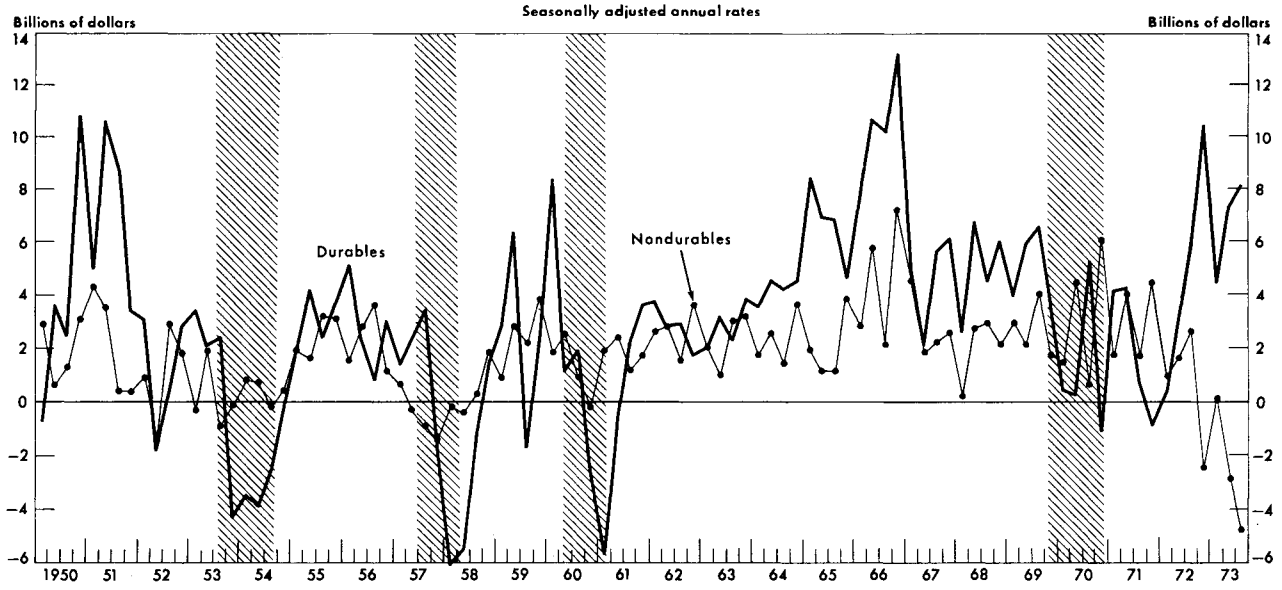
Automobile sales have moderated in recent months in response to a combination of factors affecting supply and demand. Work stoppages and parts shortages have intermittently slowed production, thus restraining supply. The demand for new cars has softened as a result of uncertainty about the effects of the energy shortage on the economy, concern with the rising price and the declining availability of gasoline, and widespread purchasing earlier in the year to avoid paying for the required antipollution and safety devices on 1974 models. Indeed, there has been a dramatic shift in the composition of demand toward smaller, more economical models. In both October and November, seasonally adjusted sales of new domestically produced passenger cars were at an 8.7 million unit annual rate, down from the 10.1 million unit pace averaged over the first nine months of the year. Some slowing in the rate of new car sales was widely anticipated even before the 1974 models were launched, but the current pace is probably slower than expected.

Residential construction has continued to retreat from the high levels experienced throughout 1972 and earlier this year. The contraction in housing activity reflects to a considerable extent the tightness of mortgage credit, although some decline in the previous unsustainable pace of expansion would have occurred in any event. In October, housing starts dropped to an annual rate of 1.61 million units, the lowest in three years and well below the year-earlier rate of 2.45 million units. Over the year ended in October, starts of multifamily structures fell

Chart I

NONFARM INVENTORY INVESTMENT IN THE GNP ACCOUNTS

Seasonally adjusted annual rates



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.

sharply; such starts decreased 41 percent, compared with the 28 percent decline for single-family dwellings. On a regional basis since October 1972, starts have dropped most in percentage terms in the South, least in the north central states, and by about the same magnitude in the Northeast and the West.

Deliveries of mobile homes have also slowed abruptly from a record seasonally adjusted annual rate of 740,000 units this past March to 470,000 units in September. Sales of new one-family homes edged up slightly in September, while inventories of unsold single-family homes moved down to 9.8 months of sales, a bit lower than the August ratio but still substantially higher than any other month on record. Further confirmation of the slack in the residential construction sector comes from evidence on the amount of time it takes a new one-family home to be sold from the start of construction. During the third quarter, a median of 4.4 months (seasonally adjusted) elapsed from groundbreaking to sale. This is below the median of 4.8 months posted over the second quarter but is still well above the 3.1 months "for sale" time averaged in 1972.

INDUSTRIAL PRODUCTION, INVENTORIES, AND ORDERS

The Federal Reserve Board's index of industrial production, which measures the physical output of the nation's factories, mines, and utilities, rose at a 6.6 percent seasonally adjusted annual rate in October. This increase is in keeping with the slower growth in output that characterized the second and third quarters when output rose at a 5½ percent annual rate, about half as fast as in the preceding year.

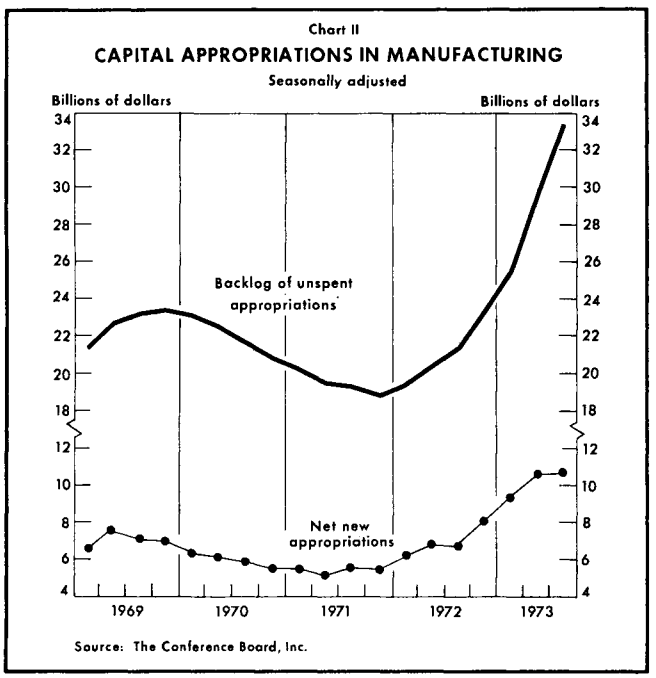
Gains in production in October were registered in all major categories, with the notable exception of a decline in industrial materials output at a 2.7 percent annual rate. This was the first drop in materials output in about two years. Production of motor vehicles and parts registered its second consecutive monthly gain after falling sharply in August because of a variety of production difficulties, including parts shortages for the 1974 automobiles. Passenger car production was at a 9.4 million unit pace in October, below the record 10.3 million unit rate of July. Production rose to 9.6 million units in November, but it is unlikely that this pace will be maintained during the next few months, given the trimming of assembly schedules recently announced by the three major producers of automobiles. The precise impact of the announced plant closings on industrial output depends on the extent to which the shutdowns are only temporary and reflect a reorientation of productive capabilities toward the production of smaller cars.

The energy category of industrial production, which includes electric power and gas utilities and petroleum refining, accounts for a sizable 11.2 percent of the total index. Energy output rose at an annual rate of 4½ percent in October, as it was apparently too early for the boycott on oil shipments to the United States to have any pronounced effects. Over the year ended in October, energy production grew 4.2 percent, considerably slower than the 7.2 percent rise of total industrial output. Over the longer period spanning the past ten years, energy production and overall industrial production have increased at about the same rate of 5 percent per year.

Inventory accumulation has remained surprisingly sluggish throughout 1973. The third-quarter change in business inventories reported in the GNP accounts was revised down to a weak $4.7 billion. Inventory investment during the first three quarters of 1973 has averaged about $4½ billion per quarter, substantially below the $8½ billion rate of accumulation averaged during the second half of last year. On the other hand, increases in the book value of total business inventories have tended to be considerably stronger in 1973 than during the previous year. For example, the book value of inventories rose at an annual rate of about $21 billion in the first nine months of this year, which is about 50 percent faster than the rise experienced over the second half of 1972. This marked discrepancy between inventory gains on a book value basis and in the national income accounts is explained by the impact of rapidly rising prices. Inflation generates inventory capital gains, which boost changes in the book value of inventories. However, the GNP accounts, anchored in the concept of current production, record changes in physical stocks only.

The recent sluggishness of inventory spending on a national income accounts basis stems largely from the dramatic and persistent weakening of nondurables inventory investment over the past year (see Chart I). In previous business expansions, nondurable stocks rose relative to their recession levels. Durables inventories, while more in keeping with past cyclical patterns, are also quite lean, as indicated by the fact that the ratio of inventory book value to sales is at its lowest level since 1965.

New orders placed with manufacturers of durable goods rose in October by a substantial $1.7 billion after declining in the three previous months. The advance was mainly in orders for primary metals, machinery, and transportation equipment. Orders placed for nondefense capital goods increased in both September and October and currently stand just a shade below the record June level. In the first ten months of 1973, durables bookings have expanded at around an 18 percent annual rate, after increasing almost 23 percent in 1972. Because durable goods prices have



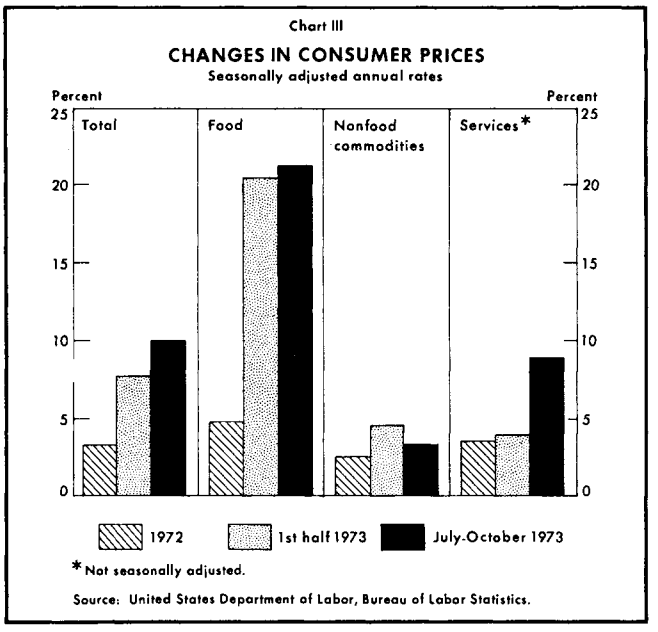
been accelerating more rapidly in 1973, the above comparison understates the slowdown in the expansion of real bookings relative to last year. This slower rise may in part reflect supply factors. Long delivery lead times, high rates of capacity utilization, and huge orders backlogs suggest that many industries are close to being booked to capacity.

The backlog of unfilled orders for manufacturers' durable goods continued to mount in October, reaching a level that was about 35 percent higher than a year earlier. While the ratio of durables manufacturers' unfilled orders to shipments moved down slightly to 2.58 in October, it is still substantially higher than the ratio of a year ago.

The presence of sizable orders backlogs has probably bolstered business plans to expand capacity in 1974. Based on its most recent survey, McGraw-Hill reports a 14 percent planned increase in new plant and equipment spending in 1974. This is comparable to the 12 percent planned rise estimated by Lionel D. Edie & Company Inc. and the 15 percent increase cited by Rinfret-Boston for 1974. The Commerce Department's first readings project business fixed investment to climb at about a 13.3 percent annual rate over the first half of 1974. Respondents to the McGraw-Hill survey anticipated a 7 percent rise in plant and equipment prices together with an increase of 7 percent in real outlays. In the manufacturing sector, capital spending is projected to climb by a very substantial 24 percent next year. The Conference Board's survey of the 1,000 largest manufacturing firms reports that net new capital appropriations climbed by about $0.2 billion to $10.6 billion in the third quarter, compared with an average $6.9 billion in 1972. The backlog of appropriated but unspent funds reached $33.3 billion, up $12 billion from a year earlier (see Chart II). Even if the growth of new appropriations slows in coming quarters, the huge backlog of appropriated but unspent funds could serve to maintain a high rate of capital spending. The surveys were taken prior to the oil embargo, and the effect of the energy situation on the magnitude and direction of change in overall investment is uncertain. Shortages of petroleum-related inputs may postpone some projects, but capital expenditures in energy-producing industries could exceed previous estimates.

RECENT PRICE DEVELOPMENTS

There are not as yet any signs of a fundamental diminution in inflation. In October, the consumer price index rose at a very rapid seasonally adjusted annual rate of 9.9 percent. Month-to-month fluctuations in the price data have been affected by changes in the Economic Stabilization Program and may therefore be misleading. However, over the four months ended in October, consumer prices rose at a 10 percent annual rate, faster than the 7.8 percent rise of the first half of the year and much more



rapidly than the 3.4 percent increase during 1972 (see Chart III). Since October 1972, consumer prices have jumped 7.9 percent, marking the largest twelve-month climb since the Korean war period.

A major contributor to the overall rise in consumer prices in October was the surge in prices of services, which climbed at a 13.7 percent annual rate, the largest monthly increase on record. The October climb was paced by another large increase in home-mortgage costs and by the once-a-year adjustment of medical care costs. Even apart from these factors, the rise in the price of services was substantial. Consumer food prices, which had fallen slightly in September, rose at a 6.5 percent annual rate in October, bringing the increase in food prices over the July-October period to 21.3 percent, about the same as the 20.4 percent burst of the first half of the year. Meat, poultry, and egg prices fell in October, but this was offset by rising prices of most other major components of the food-at-home index and higher prices for food away from home.

Prices of nonfood commodities rose at a 5.8 percent annual rate in October. Over one third of the increase in nonfood commodities prices stemmed from higher costs of gasoline and fuel oil. It should be noted that the October price data were gathered largely before the start of the Arab boycott of oil shipments to the United States. Strong demand has put substantial upward pressure on energy prices for some time. For example, fuel oil and coal prices soared almost 20 percent during the year ended in October and gasoline and motor oil prices rose 10 percent. Gasoline and oil prices carry a weight of less than 4 percent in the overall consumer price index. However, further price increases, either through the imposition of excise taxes or rising market prices, will certainly have a broader impact on consumer prices than is suggested by the weight of the component because of the pervasive role of fuel in the production of the items included in the index.

Wholesale prices jumped by a very large 21.1 percent seasonally adjusted annual rate in November, as soaring energy prices swamped another decline in agricultural prices. The fuel and power category, which has a weight of 7 percent in the overall wholesale price index and 10 percent in the closely watched industrial commodities component, exploded at a 19.3 percent monthly rate—a 232 percent annual rate—in the face of the Arab oil embargo. At the same time, the Cost of Living Council has modified its regulations pertaining to price increases for petroleum products. Even when fuel and power are excluded, prices of wholesale industrial commodities climbed at a 13 percent annual rate, up from 9.4 percent in October and 8 percent over the first nine months of this year. Prices of farm products and processed foods and feeds fell 17.7 percent at an annual rate in November for their third consecutive monthly decline, but were still 31.2 percent higher than a year ago.

WAGES AND EMPLOYMENT

Although wages are rising rather modestly by comparison with the very rapid climb in the cost of living, they have nonetheless stepped up their rate of growth. According to preliminary data, the hourly earnings index for private nonfarm production workers—which is adjusted for the effects of interindustry employment shifts and manufacturing overtime—rose at a slow 3.2 percent seasonally adjusted annual rate in November. Changes in the index are somewhat volatile on a month-to-month basis; it is helpful to examine longer time spans for signs of emerging trends. Over the past six months, basic wage rates as approximated by the index have climbed at a 7.5 percent annual rate, noticeably faster than the 5.8 percent rise of the preceding half year.

On balance, the mixture of data gathered in November suggest that no sudden change in labor market conditions took place during the month. It is important to note that, given the timing of the data collection, the Arab oil embargo had little or no effect on these particular statistics. According to the household survey, seasonally adjusted employment was essentially unchanged following the very large gains recorded during each of the preceding two months. During the past year, employment has expanded by a vigorous 3.8 percent, compared with the gain of 3.2 percent during the twelve months ended in November 1972. While small, the growth of the labor force during November was large enough to push the unemployment rate up by 0.2 percentage points to 4.7 percent, which is the average for the preceding four months.

In the separate November survey of nonfarm establishments, seasonally adjusted employment rose by around 200,000 workers, a bit less than the average monthly gain posted over the first ten months of the year. Because of differences in coverage, sampling techniques, and seasonal patterns, the payroll and household surveys often diverge on a monthly basis but tend to show comparable changes over somewhat longer periods of time. Manufacturing employment went up by around 50,000, less than half the October gain but a little above the rate averaged over the second and third quarters. Although November employment increased, both the average workweek and overtime hours for manufacturing production workers remained unchanged at levels well below the recent peaks recorded earlier in 1973.

FEDERAL RESERVE BANK OF NEW YORK

The Business Situation

The economy has continued noticeably less buoyant in recent months than in the early part of 1973. More subdued consumer demand, capacity limitations, and supply bottlenecks have all contributed to the slower rate of economic expansion. As the effects of the embargo on Arabian oil exports to the United States begin to make themselves felt, the productive capacity of the economy will be further constrained. Although Administration estimates of the petroleum shortage during the next few months have been revised downward, the projected shortfall is still large and its impact on the economy remains uncertain. Much depends on the duration of the embargo, the extent to which nonessential energy consumption can be curtailed, and the overall efficacy of the Government's oil allocation program.

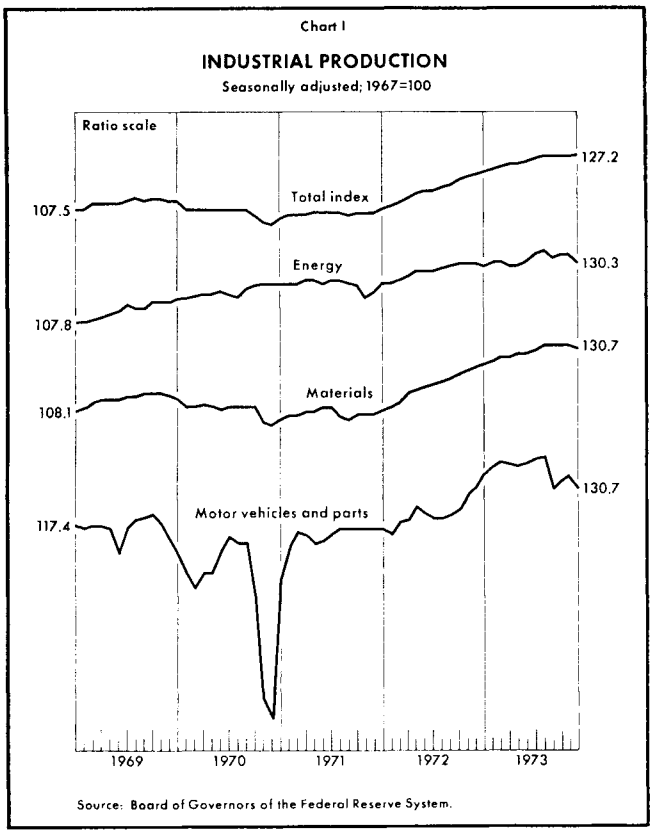
The latest available data on the business situation cover a period when there was still little adverse effect from the Mideast oil embargo—aside from that on prices and automobile sales. Industrial production increased only slightly in November, with the magnitude of the gain as well as of those in the two previous months considerably smaller than the advances recorded earlier. The less rapid growth in production in recent months has been, to a considerable extent, the result of capacity limitations and shortages of materials, as evidenced by the high backlog of unfilled orders and the unusually lengthy lead times between orders and deliveries. However, the less vigorous demand for consumer durables has also contributed to the slower growth. This ebbing in demand for consumer durables, especially noticeable with regard to automobiles, resulted in the advance estimates of retail sales for November remaining virtually unchanged, even before making allowance for rising prices. New car sales declined further during December, owing partly to a rapid shift in demand for gas-economizing models, which were not available in sufficient number. The housing slump remained quite evident in November, despite a small rise in starts. Unemployment rose to 4.9 percent of the labor force in December, the second straight monthly increase from the 3½-year low of 4.5 percent reached in October. The December data were gathered too early to have been significantly affected by the oil embargo.

The price situation reflects widespread upward pressures, with no relief in sight. In November, the consumer price index was rising at an annual rate of around 9½ percent. Soaring prices of gasoline, motor oil, fuel, and utilities, along with large increases for food commodities, accounted for much of the jump. In December, the wholesale price index surged at an annual rate of over 26 percent, seasonally adjusted. The increases were particularly large for fuels and power, but they were also very sizable for other industrial commodities and for farm products.

INDUSTRIAL PRODUCTION, ORDERS, AND INVENTORIES

The Federal Reserve Board's index of industrial production, seasonally adjusted, posted a modest 2 percent annual rate of advance in November. By comparison, this measure of the output of the nation's factories, mines, and utilities had increased at a 3.3 percent annual rate in the previous four months, at a 7.4 percent annual rate during the first half of the year, and at a 12 percent rate during 1972.

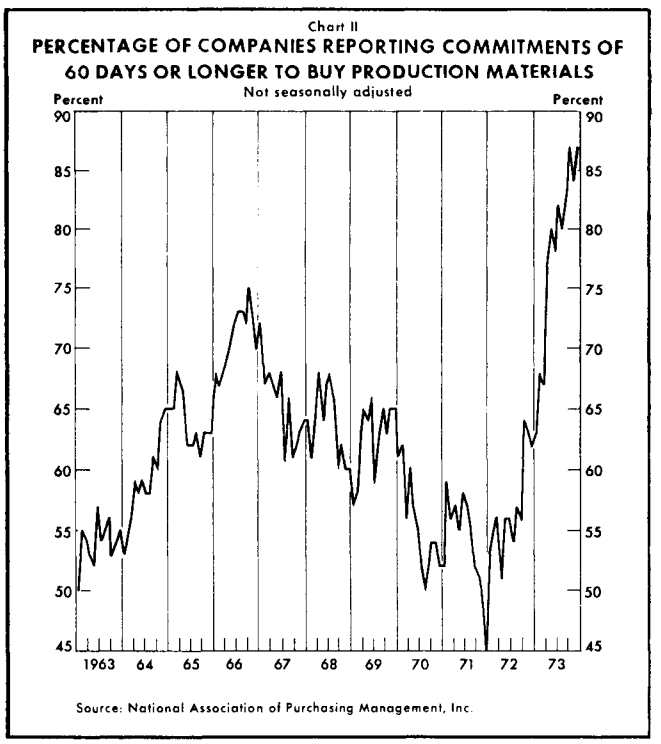
Decreases in the production of energy, materials, and automotive products contributed to the stunting of the November advance in the overall index (see Chart I). The energy component encompasses the fuel extractive industries, the gas and electric utilities, and the petroleum- and coke-refining industries. Crude oil deliveries from the Mideast had not been unduly interrupted in November; the decline in energy production reflected, rather, a marked cutback in electricity consumption, apparently because of conservation measures as well as the unusually mild weather. Widespread shortages of raw materials seem to have been mainly responsible for the slight dip in the production of materials. In recent months, capacity limitations that have prevented further expansion of output by ma-



terials producers have constituted bottlenecks for the rest of the economy, severely limiting the overall rate of economic expansion. The developing energy shortage is likely to exacerbate this situation in coming months. At present, however, it is the automotive industry that has been most affected by the uncertainties engendered by the oil embargo. Although declines in truck, bus, and parts output accounted for the big November drop in the production of motor vehicles and parts, a weakening in demand for passenger cars has been very apparent. While auto assemblies rose to a 9.6 million unit pace in November, they fell to an 8.2 million unit rate in December according to preliminary estimates. The temporary closing of a number of automobile assembly plants, in part to reorient production toward the smaller-sized models, will serve to hold down production in the near-term future as well.

In November, the seasonally adjusted flow of new orders received by durable goods manufacturers rose by $400 million, less than one fourth of the spurt of the previous month. The November gain, attributable mainly to enlarged bookings for nondefense capital goods, amounted to a 10.7 percent annual rate of increase. In the year ended May 1973, new bookings had expanded 25 percent. Between May and October of this year, however, the annual growth rate slowed to 9 percent. Moreover, much of the increase since May has centered in orders placed for capital goods, defense as well as nondefense items. Indeed, excluding nondefense and volatile defense capital goods orders, the growth rate in new bookings amounted to 25.9 percent for the year ended May 1973 and to only a 4.6 percent annual rate for the May-November period.

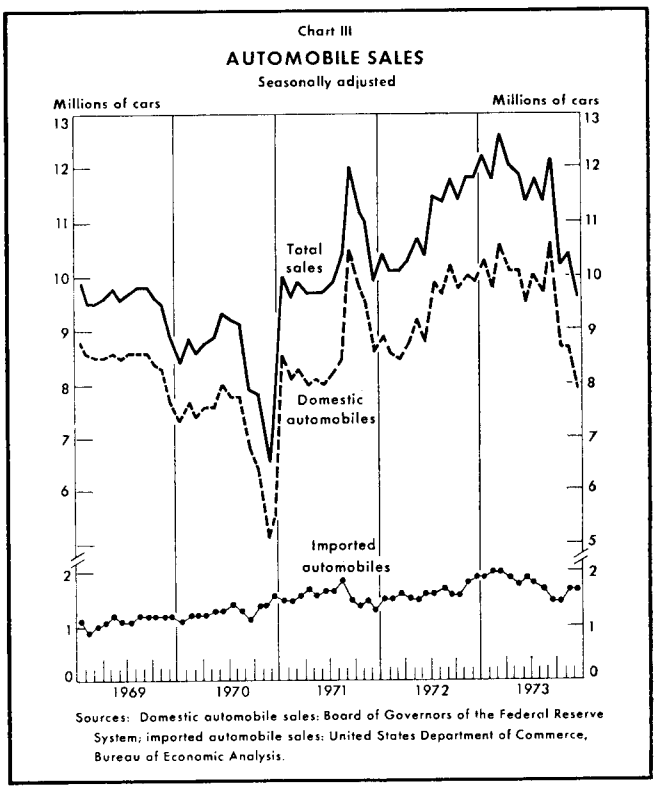
Despite the recent slowing in orders and continuing additions to capacity, the lag between the placement and the delivery of orders still is unusually long. In November, the increment to the backlog of unfilled durables orders amounted to $2.5 billion on a seasonally adjusted basis, about the same as the increase averaged in the first ten months of the year. The ratio of unfilled durables orders to sales rose to 2.62, the highest level in recent years. Data gathered from other sources also suggest that the delivery lag is still lengthy. For example, the National Association of Purchasing Management's survey for December showed that the percentage of its respondents reporting commitments of at least sixty days to buy production materials was



again at its post-Korean-war high, initially reached in October (see Chart II).

Throughout the first ten months of the year, the book value of total business inventories has grown at a rate about double that of 1972. Much of this acceleration, however, reflects the faster pace of inflation rather than a buildup of physical stocks. Because business sales are affected by inflation in much the same way as the book value of inventories, the inventory-to-sales ratio tends to be a more accurate indicator of inventory conditions than the change in inventories alone. In past business expansions, the inventory-to-sales ratio fell during periods of rapid real growth and started to climb when growth slowed, as growth has over the second and third quarters of 1973. The ratio declined to a post-Korean-war low of 1.41 this past July, hesitantly rose in the next two months, but then fell back to the July level in October, the latest month for which data are available. Widespread shortages of materials have been in part responsible for businesses being unable to build up desired buffer stocks of inventories.

In November, the book value of manufacturers' inventories rose at a $13.4 billion seasonally adjusted annual rate, about the same as the gain in the previous month but somewhat above the pace recorded during the first nine months of 1973. A fairly rapid increase in shipments resulted in a trimming of the manufacturing inventory-sales ratio to 1.54, a post-Korean-war low. While the stock-sales ratio for durables remained essentially unchanged, the ratio for nondurables sank to 1.16, the lowest reading on record.



PERSONAL INCOME, CONSUMER DEMAND, AND RESIDENTIAL CONSTRUCTION

Personal income advanced in November at a seasonally adjusted annual rate of $8.7 billion, off slightly from the $9 billion gain of the previous month. Though sizable, the recent increase marked the third consecutive month that the rate of growth in personal income has slowed. The November rise was diffused across all the major income categories. Wage and salary disbursements expanded at a $5.6 billion pace, similar to the monthly gain averaged during the first ten months of 1973. Over the twelve months ended November, personal income grew by about 10 percent, slightly less than the gain recorded during 1972. The slowdown in real personal income has been larger as a result of accelerating inflation.

Prior to the Arab oil embargo, automobile sales had been expected to moderate from the hectic and presumably unsustainable pace of earlier this year. With the imposition of the oil embargo, the decline in automobile sales has been even severer than had been anticipated. In response to the sudden and unexpected changes in gasoline cost and availability, both the level and the composition of demand for autos have been markedly altered. Retail sales of large cars have fallen substantially, while sales of smaller, gas-economizing models have gone up. During December, sales of domestic cars declined to a seasonally adjusted annual rate of 7.9 million units. This was well below the rate of 10 million units averaged over the first three quarters of the year (see Chart III). The decline reflects both a fall in the total demand for new cars and a shift in the composition of demand toward smaller domestic and foreign models, which are in short supply.

Activity in the housing sector is continuing at much the same sluggish pace as during the past few months. Throughout this period, the mortgage market has remained tight. Housing starts in November were running at a 1.7 million unit seasonally adjusted annual rate, up slightly from the previous month but substantially below the 2¼ million unit rate posted in the eight months preceding the large September decline. Over the past three months, single-family and multifamily starts have been about 25 percent below their respective average monthly rates

during the first half of 1973. Building permits continued the steady decline that began in the second half of the year, and by November stood at 1.3 million units, down only slightly from the previous month but 0.8 million units below the monthly average of the first half of the year.

Sales of new one-family homes declined in October to 523,000 units, down 26 percent from the first-half average and the lowest monthly figure in over three years. The sluggish October sales rate sent the inventories of unsold one-family homes to a record 10.7 months of sales, measured by the October level. Mobile-home sales fell for the third consecutive month, amounting in October to 444,000 units, 19.4 percent less than a year earlier and the slowest pace since March 1971.

PRICES

Inflationary pressures were undiminished in November, as the consumer price index rose at the extraordinarily high seasonally adjusted annual rate of 9.4 percent. Over the first eleven months of the year, consumer prices increased at a 9 percent annual rate, more than double the rate of growth that occurred in 1972. Much of the large November advance was attributable to the skyrocketing prices of energy items and to the resurgence of food price increases. The rise in the prices of nonenergy, nonfood consumer commodities was quite modest.

The enormous hikes in the prices of energy-related items accounted for about one third of the November advance in consumer prices. Recent decisions by the Cost of Living Council have allowed retailers to pass on higher wholesale costs of many refined petroleum products. Fuel oil and coal prices jumped at a 10 percent seasonally adjusted monthly rate, gasoline and motor oil prices rose 4.5 percent, and the increase in gas and electricity rates amounted to 1 percent. Further advances in energy prices are in the offing as a result of the intensifying effects of the Arabian countries' continuing embargo of oil to the United States and the steep increases in prices posted by members of the Organization of Petroleum Exporting Countries as well as by other oil-exporting nations. The combination of energy-related shortages and higher prices of energy items is likely to exert additional inflationary pressures elsewhere in the economy in coming months.

Inflation continues to be a most serious problem in the food sector also. In November, consumer food prices jumped at a 17 percent seasonally adjusted annual rate as declining prices for meat, poultry, and eggs were more than offset by rising costs of other foods and of restaurant meals. The November increase was the largest in three months and pushed food prices to a level 20 percent higher than a year ago.

EMPLOYMENT

According to the December household survey, the unemployment rate registered its second consecutive monthly increase of 0.2 percentage points. This brought the seasonally adjusted jobless rate to 4.9 percent, compared with the 3½-year low of 4.5 percent reached this past October. During December, as in November, employment edged down and the labor force grew by a small amount. Because the timing of the survey was such as to include only those individuals who were unemployed during the first week of the month, the December data were little affected by the repercussions of the oil embargo. Layoffs at automotive plants and among airline personnel, for example, have been concentrated in the weeks since the survey was taken.

A DAY AT THE FED

A Day at the Fed, a new 28-page booklet, takes the reader on a behind-the-scenes "what", "how", and "why" tour of the New York Fed. The documentary-type narrative provides a panoramic view of the Bank's varied operations and its role in the Federal Reserve System and the economy.

A Day at the Fed is available without charge from the Public Information Department, Federal Reserve Bank of New York, 33 Liberty Street, New York, N.Y. 10045.

The Business Situation

The most recent business statistics provide further evidence of a slowing in the economy. During the past quarter, real gross national product (GNP) edged up at a seasonally adjusted annual rate of 1.3 percent, the slowest pace in three years. In the last month of the quarter, industrial production actually declined, following three months of very small gains. Some of this recent braking clearly reflects the impact of the embargo on oil shipments from the Arab oil-producing nations, announced late last October, with all of the December decline in industrial production traceable to reductions in the output of "energy" and automotive assemblies. Actual and anticipated fuel shortages contributed to a fairly broad-based rise in unemployment from 4.8 percent in December to 5.2 percent in January.

Some slowing in the economy was generally expected even before the petroleum situation moved to center stage, and would almost certainly have taken place even if ample supplies of oil had continued to be available. Shortages were an important factor; these were widespread up to and including the final quarter. Indicative of this was the extraordinarily high level of capacity utilization in the major materials industries during the last quarter. Despite a slight decline from the third-quarter rate, the October-December figure was the second highest quarterly utilization rate on record. Price controls contributed to the shortages, since they led to changes in output patterns and also induced producers to expand exports, which are not subject to domestic price controls.

The price situation has gone from bad to worse in recent months, with prices of fuel and power skyrocketing. The rise in the GNP deflator continued to accelerate during the fourth quarter and reached an annual rate of 7.9 percent, the fastest climb since the Korean war. Wholesale prices soared at a 26 percent annual rate in December, after registering a 21 percent increase in November. A broad-based advance in all the components was evident, even though fuel and power prices, which increased at the phenomenal annual rate of 146 percent in December and 157 percent over the last three months, had an overwhelming effect on the index. For the entire year, wholesale prices rose by 18.2 percent, the highest rate since the end of World War II. Although the upward march in consumer prices "slowed" to an annual rate of 6½ percent in December, the rapid run-up in wholesale prices has not yet been fully felt at the retail level. During the past year, consumer prices climbed 8.8 percent, the fastest advance since price controls were terminated after World War II.

Cost pressures during the final quarter of 1973 intensified, as rapidly rising wages and declining productivity generated the largest unit labor cost increase in four years. Prospects for a moderating of the pace of wage changes are diminished by the fact that real wages declined over much of 1973. Moreover, a heavy collective bargaining schedule is anticipated for 1974.

GNP AND RELATED DEVELOPMENTS

The market value of the nation's output of goods and services rose $29.5 billion during the fourth quarter to a seasonally adjusted annual rate of $1,334 billion, according to the preliminary Commerce Department estimates. Measured in current dollars, GNP climbed at a 9.4 percent annual rate, but nearly all of this advance reflected higher prices; after adjustment for changes in the price level, GNP expanded at a 1.3 percent rate, the slowest pace in three years (see Chart I).

Although the Arab oil embargo had some impact on real growth during the fourth quarter, a slowing had become apparent earlier in the year. During the two middle quarters of 1973, real growth averaged about 3 percent per year, after having risen 8 percent during the twelve months ended March. A comparable deceleration in the growth of the Federal Reserve Board's index of industrial production, which measures the physical output of the nation's factories, mines, and utilities, has also occurred. Over the four quarters ended last March, the expansion in industrial production averaged close to 12 percent. It then slowed to about 6 percent in each of the next two quarters and to less than 1 percent in the final quarter. In December, industrial production registered its sharpest decline in more than two years. However, excluding the energy component,

which encompasses such activities as the extraction and processing of fuels as well as the generation of power, and the motor vehicles and parts component, which has also been strongly affected by the oil situation, industrial production rose in December.

Inventory investment added $11.2 billion to the growth of GNP during the fourth quarter (see Chart II). According to estimates based on incomplete data, the change in business inventories soared from the small $4½ billion annual rate of accumulation averaged during the preceding three quarters to a huge $15.9 billion climb in the October-December period. Final expenditures—GNP net of inventory accumulation—rose only about half as fast as in the earlier quarters of 1973, as spending on consumer durables and residential construction declined sharply.

The abrupt rise in inventory investment represents the outcome of a diverse set of factors. As in the preceding quarter, there was a run-up of farm inventories ($1 billion, annual rate), with farmers probably increasing their holdings in anticipation of higher prices. Many other businessmen were undoubtedly attempting to build up inventories from the very low levels to which they had been pushed by the exceptionally rapid growth of final demand and the widespread supply shortages that have characterized much of the recent past. However, the most dramatic development was the $4.5 billion surge in passenger car inventories held by auto dealers (see table), while some of this buildup was voluntary, in response to the depletion of dealer stocks during the earlier part of the year, most of it reflects the marked weakening toward the end of 1973 in the demand for standard-size cars. As sales dropped, dealer stocks of domestic-type cars went from the equivalent of forty-two days of sales in September to sixty-nine days in December. The present imbalance of auto inventories is underscored by industry reports that supplies of certain slow-selling large vehicles currently are equal to several months of sales while for some of the much-sought-after subcompacts supplies are extremely short.

The pace of overall consumer spending slowed dramatically during the fourth quarter. Current-dollar outlays expanded by only $13 billion, compared with the $20.4 billion advance registered in the previous quarter and an

Chart I

PERCENTAGE CHANGES IN REAL GROSS NATIONAL PRODUCT

From previous quarter; seasonally adjusted annual rates

Note: Shaded areas represent recession periods, indicated by the National Bureau of Economic Research chronology. The dates of the 1969-70 recession are tentative.

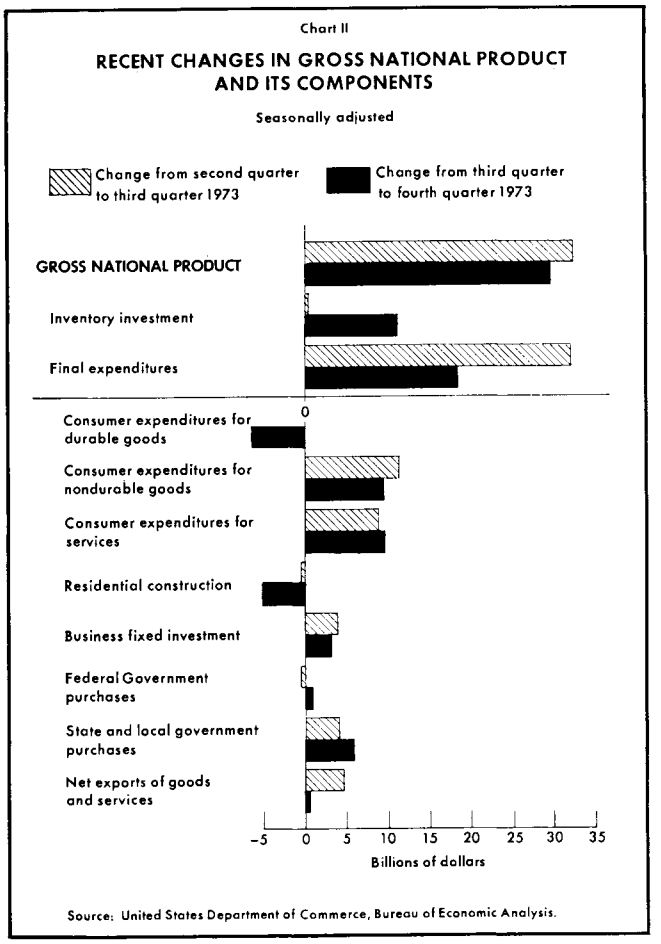
Source United States Department of Commerce, Bureau of Economic Analysis.

average increase of $19.1 billion per quarter over the year ended in June. When stripped of the sharp price increases, the recent sluggishness of consumer spending emerges even more clearly, showing an actual decline in the fourth quarter at a 2.6 percent annual rate. This was the first decline since the final quarter of 1970, when the recession and a lengthy strike at General Motors had combined to produce an even larger drop.

Current-dollar spending on consumer durables, which had shown a very sizable increase in the first quarter of 1973 and had remained essentially flat for the next six months, declined in the fourth quarter by $6 billion. Expenditures on passenger cars plummeted $7.1 billion (see table), a decline comparable in both current dollar and real terms to the drop that occurred during the auto strike of three years ago. Although some slowing in the pace of new car sales was widely anticipated well in advance of the launching of the 1974 models, the magnitude of the decline has surpassed most expectations. The Arab oil embargo and accompanying uncertainties as to the availability and cost of gasoline have taken their toll on the auto industry. They have not only weakened the demand for new cars beyond the amount of slippage that might otherwise have occurred, but have also precipitated a strong shift toward smaller vehicles. However, parts shortages and capacity limitations have constrained the production of smaller cars both at home and abroad and lengthened delivery times. Consequently, sales of new passenger cars—domestic types and imports combined—dropped from the record annual rate of 12.6 million units reached this past March to a seasonally adjusted annual rate of 9.6 million units in December. In January, sales of new domestic cars, which had been at a seasonally adjusted annual rate of 7.9 million units in December, slipped to 7.7 million units. This compares with a fourth-quarter average of 8.4 million, and a peak rate of over 10 million reached during the first quarter of the year.

Spending on nondurable goods also weakened during the fourth quarter, with real outlays showing a decline. Although current-dollar outlays for both food and gasoline rose appreciably in the face of rapid price increases, real consumption fell in both categories. The decline was especially acute with respect to gasoline and motor oil. Expenditures for services, on the other hand, continued quite strong—both before and after adjustment for price increases.

Business fixed investment advanced by a comparatively modest $3.1 billion. This was somewhat slower than in the preceding two quarters and only about half as fast as the rapid growth during the final quarter of 1972 and the opening quarter of 1973. During October-December, business purchases of passenger cars dropped by $1.2 billion to the slowest pace in almost two years (see "producers' durable equipment" in the table). The petroleum outlook, including its implications for the resale price of larger-size cars, was at least partly responsible for this decline.



The important role of automotive developments in the evolution of fourth-quarter GNP is summarized in the table. These data show those portions of GNP that arise from expenditures on passenger cars. They comprise consumer spending on passenger cars, the part of business fixed investment that takes the form of passenger car purchases by business, and the portion of the change in business inventories that is accounted for by dealer holdings of cars. The difference between auto exports and auto imports (the latter including passenger cars assembled in Canada for sale in the United States) also enters into the calculation of gross auto product.

As the table shows, following the big drop in auto pro-

duction during the General Motors strike near the end of 1970 and the sizable rebound immediately thereafter, auto product remained virtually flat through the first half of 1972. This was followed by a period of dramatic growth, with real auto product rising at an annual rate of more than 32 percent over the three quarters ended March 1973. This compared with a rise of less than 8 percent in total real GNP (see last line of table) over the same period. Thus, the increase in gross auto product accounted for fully 20 percent of the increase in real GNP. As 1973 wore on, however, gross auto product began to decline, contributing significantly to the slowing in overall economic activity. During the middle two quarters of the year, auto product growth was restrained by the fact that the industry was operating at or close to maximum capacity, and the third quarter was additionally plagued by a variety of supply problems. The fourth-quarter decline, as indicated above, was clearly related to the weakening in demand for the larger new cars. Although a sharp rise in dealers' inventories offset much of this decline in final demand, it is unlikely that this will continue, given the substantial downward adjustment of domestic auto production that is currently under way.

The demand for fixed investment goods as a whole still appears quite strong. The latest Commerce Department survey, which was conducted during November and December—after the announcement of the Arab oil embargo—indicated that businessmen are planning to increase their capital spending 12 percent above 1973 levels. Of course, when adjusted for anticipated price changes, the implied increase is substantially less. Nonetheless, it is interesting that the planned rise showed no significant decrease from projections made on the basis of information gathered somewhat before the oil embargo was instituted—namely, 12 percent in the Lionel D. Edie survey and 14 percent in the McGraw-Hill survey. However, many of these intentions are still tentative and may involve no firm commitment on the part of business firms.

Residential construction spending during October-December dropped $5 billion. This had been foreshadowed by monthly data showing a decline in private housing starts, which moved down from an average in the first quarter of 1973 of 2.4 million units, seasonally adjusted annual rate, to 1.6 million in the final quarter. The high cost and limited availability of mortgage financing have played an important role in reducing the volume of housing activity. However, other forces have also contributed to the decline. Some slowing was inevitable from the fever-

GROSS AUTO PRODUCT AND ITS COMPONENTS
Seasonally adjusted annual rates

Groups	1970		1971				1972				1973			
	III	IV	I	II	III	IV	I	II	III	IV	I	II	III	IV
	In billions of current dollars													
Gross auto product	**34.2**	**22.5**	**42.4**	**40.1**	**42.4**	**38.8**	**40.1**	**42.1**	**46.5**	**45.6**	**51.5**	**51.2**	**49.6**	**45.7**
Personal consumption expenditures	29.7	23.4	34.3	34.3	37.1	35.9	36.6	38.1	41.8	41.2	45.1	44.6	44.5	37.4
Producers' durable equipment	5.2	4.1	6.1	6.1	6.5	6.3	6.5	6.7	7.4	7.3	8.0	7.9	7.8	6.6
Change in dealers' auto inventories	0.3	—3.3	4.0	1.6	1.2	—1.2	—0.4	—0.4	—0.8	—0.4	0.9	1.2	—0.5	4.5
Net exports	—1.5	—2.1	—2.3	—2.3	—2.9	—2.8	—2.9	—2.8	—2.3	—2.9	—2.8	—2.9	—2.7	—3.3
	In billions of 1958 dollars													
Gross auto product	**31.6**	**20.0**	**37.1**	**34.8**	**37.8**	**35.8**	**36.1**	**37.7**	**41.0**	**41.4**	**46.4**	**45.5**	**43.6**	**40.6**
Addendum:														
Gross national product	**726.8**	**718.0**	**731.9**	**737.9**	**742.5**	**754.5**	**768.0**	**785.6**	**796.7**	**812.3**	**829.3**	**834.3**	**841.3**	**844.1**

Note: The gross auto product totals include government purchases, which amounted to $¼ billion annually during the periods shown. Because of rounding, figures do not necessarily add to totals.
Source: United States Department of Commerce, Bureau of Economic Analysis.

ish and unsustainable pace hit during 1972 and early last year. In addition, rapid increases in housing prices have probably reduced demand somewhat below where it might otherwise be. More recently, the restricted availability and increased cost of gasoline and other fuels, as well as the general uncertainties associated with the Arab oil embargo, have probably been further factors dampening housing activity. On the other hand, recent Government steps, such as that providing for expanded use of the "tandem plan", could favorably affect the near-term outlook for housing. The tandem plan allows the Government National Mortgage Association to purchase at below market interest rates up to $6.6 billion in unsubsidized Federal Housing Administration and Veterans Administration mortgages.

Spending by state and local governments rose $5.8 billion during the fourth quarter, up from the $4.7 billion growth averaged during the earlier quarters of the year. Federal spending increased $1 billion, compared with the decline of $0.4 billion in the previous quarter and the large gain of $2.3 billion averaged during the first half of the year. A Federal pay raise that took effect on October 1 led to a $1.7 billion increase in fourth-quarter Federal expenditures on wages and salaries. Excluding the pay raise, nondefense spending was up $0.7 billion and defense spending was down $1.5 billion. However, defense spending was reduced $2.5 billion by the sale of arms to Israel out of Government stocks, and net exports were raised by the same amount. Excluding both the pay raise and the arms shipment, defense spending was up $1 billion.

PRICE DEVELOPMENTS

Prices took a decided turn for the worse during the fourth quarter. According to preliminary data, the implicit GNP deflator rose at a 7.9 percent annual rate, almost a full point above that recorded in the previous quarter. For the entire year, the deflator climbed 7 percent. This was more than twice the rate of increase experienced during 1972, 1½ percentage points faster than the 1969-70 period of rapid price inflation, and the strongest spurt since the Korean war.

Partly as a result of numerous changes in the price controls program, the month-to-month behavior of wholesale prices has been exceedingly erratic. On balance, the movement has been very sharply upward. Seasonally adjusted prices of farm products, processed foods, and feeds rose at a 17 percent annual rate in December, following the astronomical leap of 232 percent, annual rate, in August and large declines in each of the next three months. By December, this component had risen 27 percent above year-ago levels. The fuel and power component of the wholesale price index soared in the final three months of the year, rising at a 157 percent annual rate after climbing at a 25 percent rate during the first nine months of the year and 6 percent during 1972. Even excluding the two foregoing index components, wholesale prices have risen extremely rapidly—at a 12.3 percent rate during the last three months of 1973, compared with an 8 percent rate during the first nine months of 1973 and a total of 3½ percent in 1972.

Consumer price increases "slowed" to a seasonally adjusted annual rate of 6½ percent in December, compared with the 9½ to 10 percent range of the October and November advances. For the entire year, prices soared 8.8 percent, more than twice as fast as during 1972 and the highest annual burst in a quarter century. Food price increases tapered off sharply during the final quarter of the year, compared with the advance during January-September; in those first nine months prices soared at a 23 percent rate, and in the last three months rose at a 9 percent rate. This deceleration, however, was dwarfed by the explosion of energy prices that accompanied the Arab embargo on petroleum shipments to the United States. Prices for consumer power and fuel, i.e., gasoline, home-heating oil, and gas and electricity, which have a total weight of about 6½ percent in the consumer price index, rose at over 40 percent, annual rate, in the final three months of 1973, compared with a rise of about 8 percent, annual rate, during the first three quarters of the year.

WAGES, PRODUCTIVITY, AND EMPLOYMENT

Recent data indicate a substantial intensification of inflationary pressures during the fourth quarter, with wages rising rapidly and productivity registering an outright decline. Hourly compensation in the private economy increased at a seasonally adjusted annual rate of 8 percent, bringing the rise over the entire year to a very substantial 8.2 percent. The 1973 increase in this broad measure of wage and fringe benefits was a full point higher than the advance in 1972, and the largest since 1968. However, because of the very rapid advance in the consumer price index, real private compensation declined for the third consecutive quarter. This erosion is almost certain to put added pressure on wage demands during 1974.

Productivity, as measured by output per hour of work in the private economy, fell at an annual rate of 1.3 percent in the October-December period. Over the preceding two quarters, productivity growth had been essentially unchanged after having risen very rapidly during the previous twelve months or so. The combination of rising hourly

compensation and declining productivity caused private sector unit labor costs to soar 9.3 percent in the fourth quarter, the largest increase since 1969. For the entire year, unit labor costs rose 7.2 percent or nearly three times the 2.7 percent rise averaged over 1972.

According to the Bureau of Labor Statistics survey of major collective bargaining agreements, contracts negotiated during 1973 provided, on average, first-year wage increases of 5.8 percent and life-of-contract gains of 5.2 percent. However, for wages and fringe benefits combined, first-year settlements averaged 7.1 percent and life-of-contract gains came to 6.1 percent. Moreover, the growth in compensation that will finally emerge under many of these contracts will undoubtedly be larger, since the Labor Department data do not include payments made under escalator-clause provisions that are contingent on movements in the consumer price index. Forty percent of the workers under major contracts concluded in 1973 were covered by cost-of-living escalator clauses.

A very heavy collective bargaining schedule is unfolding for 1974. During the year, 5.2 million workers, representing about half the working population covered by major collective bargaining agreements, will be involved in negotiations. Bargaining activity will be concentrated in the steel, canning, aluminum, construction, communications, electrical machinery, aerospace, longshore, railroad, and mining industries. More than a million additional workers come under contracts that, although not scheduled for negotiations this year, could be reopened in the event of a "national emergency".

The unemployment rate registered its third consecutive monthly increase in January, according to the household survey, rising to 5.2 percent on a seasonally adjusted basis. This compared with the 3½-year low of 4.6 percent reached this past October and the 4.8 percent level registered in December. A sharp January rise of 370,000 in the number of unemployed persons was the net result of a very large growth of more than 500,000 persons in the size of the civilian labor force and a very small increase of 142,000 persons in the volume of employment as measured by the household survey. Although month-to-month changes in the size of the labor force tend to be quite volatile, the growth in the labor force has, on balance, been rather vigorous. Over the year ended January, the civilian labor force increased by 3.5 million persons or close to 4 percent.

The January payroll survey recorded a second straight monthly decline in the number of persons employed by nonagricultural establishments. Seasonally adjusted payroll employment dropped by 260,000 persons to about the level reached this past October, with the decline concentrated in construction and manufacturing. At the same time, the average workweek for production and nonsupervisory workers dropped sharply. The abrupt decline of 0.8 hours brought the seasonally adjusted factory workweek to 39.9 hours, its lowest level in slightly more than two years.

Although the household and payroll surveys tend to give rather comparable employment readings over long-enough time spans, they often diverge on a month-to-month basis for a variety of reasons, including coverage, sampling techniques, and seasonal adjustments. A substantial portion of the January discrepancy between the household and payroll survey measures of employment is removed when the two surveys are examined from the vantage point of more comparable coverage. If the 150,000-person increase in agricultural employment is excluded, the January household survey shows a small employment decline.

Taken together, the direct and indirect effects of the Arab oil embargo have undoubtedly accounted for a considerable part of the January rise in unemployment, but it is impossible to tell how much. About half of the large January decline of 125,000 persons in manufacturing employment was centered in transportation equipment, where sizable layoffs have occurred among workers producing passenger automobiles. Although the evidence is preliminary, Labor Department analysts feel that actual or anticipated fuel shortages have been responsible for reducing employment in a variety of other areas also, such as gasoline stations, air transportation, automobile selling, and hotels and motels.

The Business Situation

Economic activity apparently declined early in 1974. Much of this weakness can be attributed to the effects of the Arab oil embargo which, while weighing very heavily on particular sectors, has had widespread ramifications. Industrial production fell in January for the second consecutive month, with reductions in energy and auto output accounting for about half of the total January contraction and all of the December decline. Sales of new domestic-type passenger cars slumped somewhat further in February to the slowest pace in three and one-half years. Personal income also dropped significantly in January, partly as a result of reduced employment in several key sectors and a widespread shortening of the workweek. A substantial portion of the rise in unemployment during recent months can be traced to the direct and indirect consequences of the energy shortage.

There are, however, some tentatively encouraging signs. Residential construction activity perked up somewhat in January, as housing starts rose from the 3½-year low of the month before and newly issued building permits also increased. In addition, retail sales registered a sizable increase in January. New orders for durable goods rose nearly 5 percent in January, after dropping more than 6 percent during the previous month, and the backlog of unfilled orders continued to climb. Recent evidence suggests that business capital spending plans for 1974 may have strengthened in the face of the energy shortage. A special survey conducted by McGraw-Hill projects a large 18 percent increase in capital outlays. Inventory accumulation has been rapid and, while extraordinary price increases have greatly inflated book values, a substantial amount of real inventory accumulation has been taking place. The accelerated pace of physical accumulation apparently represents investment that is intended by business, with the exception of the automotive sector where a substantial buildup of unsold large cars occurred late last year. Even here, though, inventories seemed to be moving toward a somewhat more balanced condition in February since new domestic auto sales once again outpaced assemblies.

Meanwhile, inflation has intensified. Based on revised data, the gross national product (GNP) deflator climbed at an 8.8 percent annual rate in the fourth quarter of 1973, up from the original estimate of 7.9 percent.[1] Led by soaring food and energy costs, prices at both the wholesale and retail levels advanced along a broad front in January.

INDUSTRIAL PRODUCTION, ORDERS, AND INVENTORIES

The Federal Reserve Board's index of industrial production declined at a 9½ percent seasonally adjusted annual rate in January after falling at a 7½ percent pace in the previous month. By way of perspective, industrial output had climbed rapidly into early 1973, rising more than 12 percent over the year ended February 1973 (see Chart I). As the year wore on, a noticeable slowing in production growth emerged; output rose at a 4.4 percent annual rate during the February-November interval, when a wide variety of capacity limitations and shortages held the rate of increase in check. The declines of December and January bear the unmistakable imprint of the Arab oil embargo. Cutbacks in automotive production and energy output accounted for all of the reduction in December and half of the January dip.

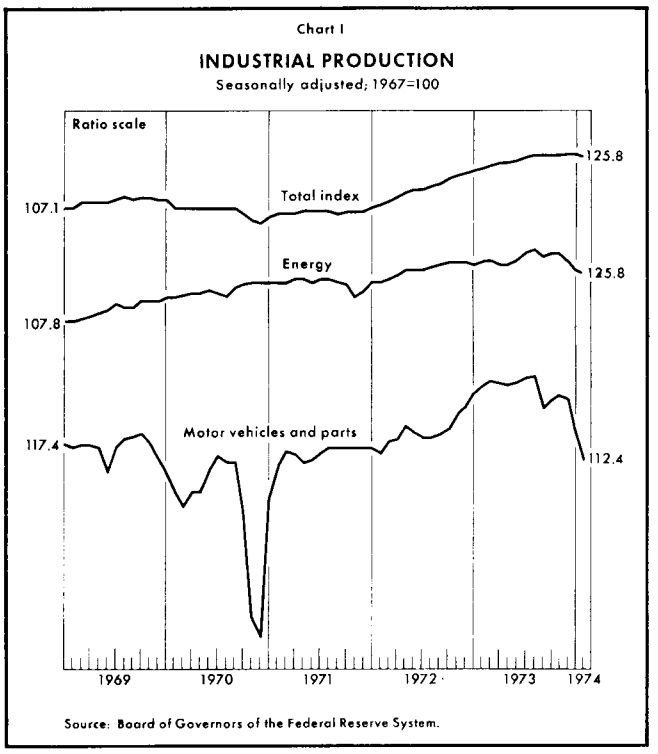
Passenger car assemblies fell 16 percent in January to a seasonally adjusted annual rate of 6.9 million units, the slowest pace since late 1970 when auto output was depressed by the strike at General Motors. Current produc-

[1] The estimate of fourth-quarter current-dollar GNP growth has been revised upward from $29.5 billion to $33 billion. Investment in business inventories was raised from a $15.9 billion to an $18 billion rate. Net exports were also raised significantly. On the other hand, consumption spending turned out to be even weaker than first indicated, with outlays up by only $9.2 billion. In real terms, GNP is now estimated to have grown at a 1.6 percent annual rate in the fourth quarter, compared with the initial estimate of 1.3 percent.

tion is symptomatic of the continuing low overall level of auto sales and the exceptionally high stocks of unsold large cars held by retail dealers. Moreover, production has been somewhat constrained because the industry is currently undergoing a major retooling process in an effort to increase production of the very popular smaller cars. Preliminary data suggest that passenger car output decreased modestly further in February.

The energy component of industrial production, which includes refined petroleum products, electric power, and gas utilities, dropped at a seasonally adjusted annual rate of 9½ percent in January after falling at a 42 percent annual rate in December. In January, energy production was off nearly 3 percent from its year-earlier level. It is interesting to note that the nation's output of energy peaked last July and began to decline somewhat before the start of the Arab oil embargo. The most recent drop continues to reflect a shortage of petroleum which is related to the embargo, as well as conservation measures taken by residential and industrial users, and the abnormally mild weather which covered much of the nation during the last half of January. On the other hand, the extraction of coal—the most abundant energy source in the United States—jumped very sharply in January. Since the imposition of the Arab oil embargo, the attractiveness of coal as an alternate source of energy has increased substantially. Several utilities along the Eastern Seaboard have been granted permission to burn coal instead of residual oil, which is in short supply. However, the index of coal output tends to be quite volatile on a month-to-month basis, and the rise early this year only served to return coal output to the approximate level reached in several months of 1973.

New orders placed with manufacturers of durable goods jumped nearly 5 percent in January, on a seasonally adjusted basis, after a drop of more than 6 percent during the previous month. Any assessment of the underlying situation is complicated by the fact that the flow of bookings has been particularly volatile during the recent past. For example, new orders declined during each month of the third quarter, but rose substantially over the next two months. On balance, the overall flow of new orders has remained sizable, with orders in January about 1.3 percent above the June-July 1973 average. During January, a large rise of $1 billion in the very volatile defense orders series was partially offset by a $0.6 billion drop in primary metal bookings. After declining in December, orders for nondefense capital goods rose $0.4 billion in January to a level 5.1 percent above the mid-1973 pace. Meanwhile, the backlog of unfilled orders continued to swell in January, and the very large backlog should serve



to bolster production in the near future.

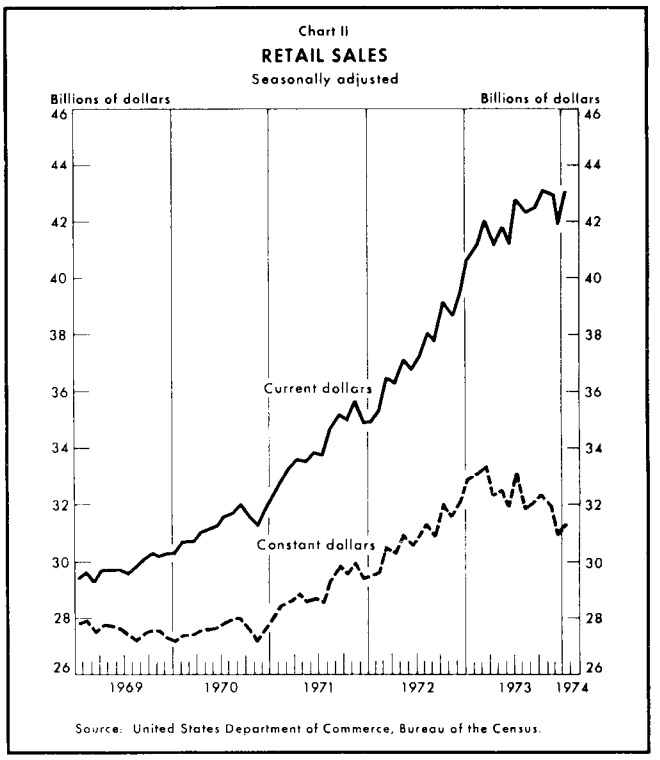
There is recent evidence that capital spending plans for 1974 have strengthened even further. A special survey conducted by McGraw-Hill during late January and early February indicated that businesses are planning to raise their plant and equipment outlays by 18 percent in 1974. This is substantially above the increases of 12 percent to 14 percent previously projected for this year on the basis of surveys conducted in late 1973 by McGraw-Hill, Lionel D. Edie, and the Commerce Department. Moreover, the most recent information suggests that the net effect of the energy situation on capital spending may be positive, even though some sectors have substantially pared their spending plans.

Business inventory spending continued its rapid rise on a book value basis in December, increasing at a seasonally adjusted annual rate of $32 billion after the record shattering $39 billion November rise. As a result, the expansion in total business inventories during the final quarter of 1973 amounted to $32 billion at an annual rate, easily the largest quarterly gain in business inventories since the end of World War II.

Some of the recent climb in inventories represents the undesired buildup of unsold large cars. During both Octo-

ber and November, the dollar value of inventories at retail automotive outlets jumped an average of $6 billion (seasonally adjusted annual rate), but this slowed significantly to a $1½ billion rate of accumulation in December. By the end of January the number of new cars in the hands of dealers had, on a seasonally adjusted basis, been reduced somewhat from the levels reached during the final months of last year. Relative to sales, however, they still remained very high. Preliminary data for February indicate that the seasonally adjusted pace of domestic-type passenger car assemblies was again below that of new car sales, suggesting that a further decline in auto inventories may have taken place. Also it is true that much of the rapid climb in the book value of inventories reflects the extraordinary rates of inflation experienced recently rather than the growth of physical stocks. Nonetheless, a substantial buildup of physical stocks also took place outside the automotive sector toward the end of 1973. As shown in the GNP accounts, the fourth-quarter change in real business inventories—excluding the very large rise in automotive dealers' stocks—was three times as large as the average increase over the first three quarters of the year. Much of this stepped-up spending appears to have been deliberate. For example, approximately half of the unusually steep December climb in the book value of durables manufacturers' inventories consisted of increased holdings of materials and supplies. This was very likely an intentional response to the widespread shortages of materials that plagued firms during much of the recent past.

The ratio of inventories to sales for all businesses rose from 1.41 in November to 1.45 in December, largely as a result of the drop in auto sales together with the buildup in auto inventories. Although the December ratio was the highest in 1973, it was still lower than at any time during the 1968-72 period. Moreover, when the automobile sector is excluded, the inventory-sales ratio was lower in December than in some earlier months of the year, suggesting that most inventories remain lean relative to sales volume.



PERSONAL INCOME, CONSUMER DEMAND, AND RESIDENTIAL CONSTUCTION

Personal income declined $4.1 billion in January to a seasonally adjusted annual rate of $1,084.9 billion. This was the first decline in nineteen months and the largest drop since July 1971, when income plunged by $10.1 billion. However, both of these earlier declines reflected mainly once-and-for-all developments. In June 1972, personal income fell mostly because of the aftereffects of tropical storm Agnes, while the earlier drop followed a big lump sum social security payment. Some of the weakness evident in January can be traced to higher social insurance contributions which are deducted from personal income. Much of the recent decline, though, is indicative of the weakening in economic activity. This is seen most clearly in the behavior of wage and salary disbursements. Wage and salary payments dropped $2.7 billion in January after having added an average of $5.7 billion to personal income during each of the preceding twelve months. The January decline was concentrated in manufacturing and construction, where falling employment and shortened workweeks reduced wage and salary payments by $3.5 billion and $1.1 billion, respectively. Farm income also declined by a substantial $2.8 billion as a result of lower subsidy payments under the Agriculture and Consumer Protection Act of 1973.

According to the preliminary estimate, retail sales in January climbed a sizable 2.5 percent above the depressed December level (see Chart II). The January rise in current-dollar sales was the largest in seven months and seemed to be fairly broad based. If this advance estimate

holds up under subsequent revisions, the nominal value of retail sales will have climbed slightly above the peak reached last November. However, in real terms, retail sales remain well below the peak level measured last March.

Sales of new domestic-type passenger automobiles slipped a bit further in February to a seasonally adjusted annual rate of 7.4 million units from January's depressed 7.7 million unit pace. During the past several months, sales of domestic autos have receded to the lowest level since the last quarter of 1970, when a strike at General Motors drastically reduced the available supply of domestic passenger cars. It may be too early to tell whether the decline in auto sales, which began with the introduction of the 1974 models and continued with the start of the oil embargo, has just about run its course. However, sales should rise as production shifts yield increased supplies of the popular small vehicles.

Residential construction activity picked up somewhat in January, as housing starts rose 6.1 percent to a seasonally adjusted annual rate of 1.49 million units in comparison with 1.40 million units started in December. While the January pace was still 40 percent below the 2.47 million units started one year earlier, the increase may mark the end of the pronounced downtrend that began in the middle of last year. The recent behavior of building permits also provides some encouragement: newly issued permits jumped 9½ percent in January to the highest rate in several months. The availability of mortgage money has been enhanced by the flow of funds to mutual savings banks and savings and loan associations. Deposit growth at these institutions, which are the major sources of mortgage lending, has strengthened considerably after tapering off dramatically during the summer months. According to preliminary data, seasonally adjusted net deposit inflows were at an annual rate of about 12 percent in January, the fastest pace since the same month a year ago. There is also some indication that inflows remained strong during February.

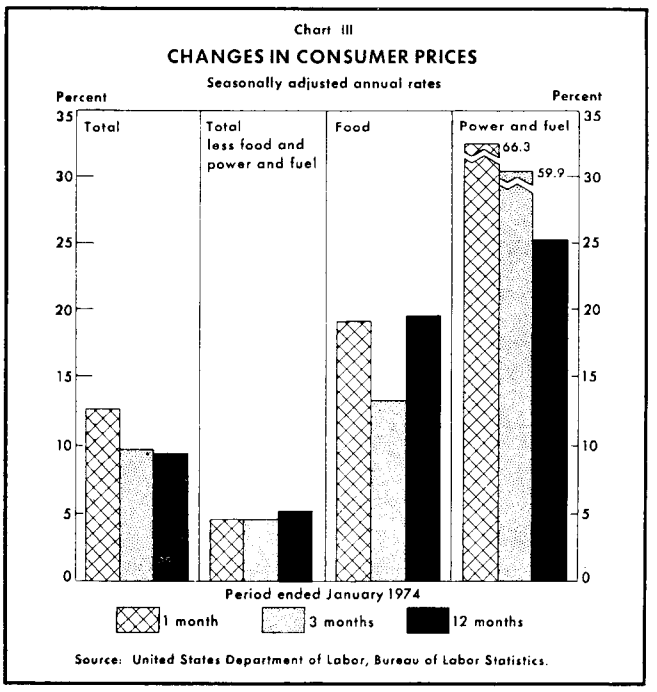
During December, shipments of mobile homes, which in recent years have represented a substantial portion of the supply of new housing, were at a seasonally adjusted annual rate of 466,000 units, about equal to the average number of shipments over the last several months. Nonetheless, current shipments are sharply below the record level of 737,000 units sold in March 1973. Sales of new single-family homes also fell sharply in December to the slowest pace in three and one-half years, while inventories of unsold homes have shown little change. Consequently, the ratio of unsold homes to sales rose to a record 12.8 months of sales, almost twice the level recorded in the year-earlier period.

PRICES

Inflation continued to intensify during January, as seasonally adjusted wholesale prices rose at a sizzling 38 percent annual rate. Although the rise was only about one half the size of the enormous post-freeze surge registered last August, it was still the second largest monthly increase in wholesale prices in more than a quarter century, underscoring the severity of the current inflation.

Perhaps the most distressing feature of the January advance in wholesale prices was its pervasiveness. Prices of farm products, processed foods, and feeds jumped at a 61 percent annual rate after declining in three of the four previous months. Over the year ended in January, these prices rose by almost 30 percent. The resurgence of food price pressures is mainly attributable to rising prices of wheat and beef. The realization that stocks of wheat are at low levels has helped push wheat prices up. Beef prices have increased in response to forces set in motion last summer. At that time, farmers reduced the volume of cattle placed on feed for winter marketing in reaction to the price ceilings placed on beef. Ceilings were lifted September 10, but this was too late to affect measurably the supplies currently coming to market.

Meanwhile, fuel and power prices leaped 82 percent at an annual rate in January, mainly because of a huge



increase in the price of crude petroleum (over 260 percent at an annual rate). Since the start of the Arab oil embargo last October, wholesale fuel and power prices have risen at an annual rate of 172 percent, compared with the rise of 25 percent in the year preceding the boycott. While energy price increases dominated the overall industrial commodities index, other industrial prices also climbed very rapidly. Excluding the fuel and power component, wholesale prices of industrial commodities rose at a 22 percent annual rate in January, the largest one-month rise on record. Over the twelve months ended in January, such prices increased 11 percent.

Consumer prices surged ahead at a 12½ percent seasonally adjusted annual rate in January (see Chart III) after rising at a 6½ percent pace in December. Except for the burst last August associated with the lifting of the second price freeze on most foods, this was the largest month-to-month increase in consumer prices since the early days of the Korean war. Advances in the prices of food and energy contributed substantially to the overall increase in consumer prices in January and in the last several months. When these two components were excluded from the index, the consumer price index rose at an annual rate of 4.5 percent in January and at the same rate during the last three months. Over the preceding year the index rose at a 5.1 percent annual rate.

Consumer power and fuel prices continued to soar, rising at an annual rate of 66 percent in January. This component, which includes gasoline, home heating oil, and gas and electricity, has increased more than 50 percent (annual rate) since the start of the oil embargo last October. At the same time, food prices rose at an annual rate of 19 percent in January. This brought the rise over the past year to 20 percent. Based on recent estimates made by the United States Department of Agriculture, food prices are expected to advance substantially in the near future.

Fifty-ninth Annual Report

The Federal Reserve Bank of New York has published its fifty-ninth *Annual Report,* reviewing major economic and financial developments and the Bank's operations in 1973.

The *Report* observed that "inflation reemerged as the paramount economic problem in the United States in 1973, exploding with a force not seen since the early days of the Korean war". With regard to monetary policy, the *Report* said that "the Federal Reserve pursued a policy of active restraint in 1973", while at the same time the monetary authorities "sought to avoid extreme pressures on financial markets which could seriously disrupt credit flows and ultimately risk generating a substantial contraction in economic activity". Although the international financial system experienced considerable stress during the first half of 1973, the *Report* noted that "the fact that the central banks were prepared to intervene to prevent the reemergence of disorderly conditions contributed to a much calmer atmosphere in the markets" during the remainder of the year.

In his letter presenting the *Report* to the member banks, Alfred Hayes, President of the Bank, stated that "we must seek to reduce inflationary pressures and to reverse the escalation of cost and price increases. Both the reconstruction of the international monetary system and the restoration of confidence in the dollar depend heavily on the resumption of a reasonable degree of price stability in the United States". Mr. Hayes added that "we must, at the same time, seek to encourage sustainable economic growth . . . . Progress toward these objectives calls for the determined, coordinated efforts of monetary and fiscal polices."

The *Annual Report* may be requested from the Public Information Department, Federal Reserve Bank of New York, 33 Liberty Street, New York, N.Y. 10045. A copy is being mailed to *Monthly Review* subscribers.

The Business Situation

Much of the overall weakness of the economy evident in the early months of 1974 can be attributed to the direct and indirect effects of the Arab oil embargo. While the embargo against the United States was substantially ended on March 19, almost five months after its inception, the latest available business statistics do not yet reflect this development. Recent data on economic activity are mixed. To be sure, in February, industrial production declined for the third consecutive month. However, there were tentative signs of a strengthening in residential construction. In addition, new orders for durable goods rose sizably in February for the second successive month, and the backlog of unfilled orders increased again. Recent capital spending surveys indicate that businessmen have stepped up their capital spending plans for 1974. Finally, sales of new domestic passenger cars steadied during March, and unemployment edged lower.

At the same time, the price situation remains dismal. Wholesale prices, led by a huge rise in prices of industrial commodities, continued to advance at an exceedingly rapid rate in March. Consumer prices rose at more than a 15 percent annual rate in February, bringing the advance in such prices over the year ended in February to 10 percent, the largest such increase in more than twenty-five years.

INDUSTRIAL PRODUCTION, INVENTORIES, AND ORDERS

As measured by the Federal Reserve Board's industrial production index, the output of the nation's factories, mines, and utilities declined at a 7.6 percent seasonally adjusted annual rate in February. Although this drop was somewhat smaller than the declines registered in December and January, it marked the first time in more than three years that output has fallen for three consecutive months. As in the two preceding months, the direct and indirect effects of the Arab oil embargo had a pronounced impact on production. Roughly half of the February decline was attributable to cutbacks in autos and auto supply industries and to reductions in energy output.

The energy component of industrial production includes electric power utilities as well as domestic fuel extraction and processing. During February, total energy output fell more than 15 percent at a seasonally adjusted annual rate, bringing the contraction since October, when the embargo began, to nearly 21 percent on an annual rate basis. Passenger car assemblies fell a bit further in February to a seasonally adjusted annual rate of 6.6 million units, almost a third below the pace of assemblies registered last November when the first effects of the oil embargo were felt. Auto production has undoubtedly been held in check in recent months by capacity limitations on the output of the popular smaller models as well as by the huge stock of slow-selling large cars. During the first half of February, production was additionally retarded by the independent truckers' strike which impeded the delivery of auto parts and materials. However, passenger car output edged up a bit in March to an annual rate of 6.7 million units.

The surge in business inventory spending moderated somewhat in January, as the book value of total business inventories rose at a seasonally adjusted annual rate of nearly $29 billion, in comparison with the record-breaking December increase of $45 billion and the $40 billion November gain. Inventory accumulation during January was still high by historical standards but, as has been the case for many months, a substantial part of the January rise represents the impact of very rapid rates of inflation on book values rather than rising physical stocks.

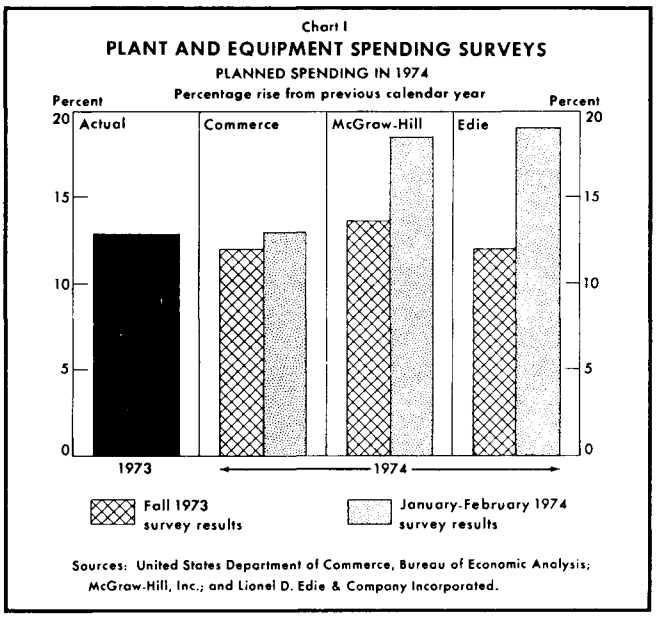
Virtually all of the January increase in business inventories occurred in the manufacturing and wholesale sectors. Retail inventories rose at only a $1.7 billion annual rate in January, a marked slowing from the $10.9 billion rate of accumulation averaged over the previous three months. A major reason for this slowdown was a halt in the undesired buildup of stocks at retail automotive outlets. Measured in unit terms, the number of unsold new cars peaked at a seasonally adjusted 1.84 million autos last November and subsequently fell to 1.63 million units by February. Despite this substantial reduction, auto inventories remain high relative to the low rate of sales.

At the February sales pace, dealer supplies of new cars equaled sixty-eight days of sales, compared with the forty-seven days' supply in stock during the first nine months of 1973 when new car sales were brisk. In terms of both units on hand and days' supply, new car inventories probably fell in March as sales exceeded production during the month.

For all businesses, the ratio of inventories to sales dropped from 1.46 in December to 1.43 in January, thus putting the ratio only slightly above the post-Korean war low of last November. The latest decline was in part the result of a strong rebound in business sales in January following the decline recorded in the previous month. Furthermore, when autos are excluded, the January inventory-sales ratio was the lowest on record, giving no indication of excess stocks outside the automotive sector.

The seasonally adjusted flow of new orders placed with manufacturers of durable goods rose sharply in February, the second consecutive month in which bookings have increased by more than 2 percent. Although these gains indicate a firm rebound from the sharp, auto-related decline of 6 percent in December, bookings still have not returned to the peak attained last November. Excluding transportation equipment, however, new orders in February were about 2½ percent above their November pace. An interesting feature of the February advance is that it was not dependent on an increase in the volatile defense orders series. In January, higher defense bookings accounted for all of the increase in durables orders, but in February such orders declined by $0.3 billion while the total rose by $1 billion. Perhaps most significant is the fact that orders for nondefense capital goods increased by $0.7 billion, or about 6 percent, in February. This is the largest rise in seventeen months and is in keeping with the latest capital spending surveys which project sizable increases in expenditures during 1974. Moreover, backlogs of unfilled orders continued to mount and by February stood 5 percent above last November.

According to the most recent Commerce Department survey—conducted during late January and early February—businesses plan to increase expenditures on plant and equipment by 13 percent during 1974. This is about equal to the actual increase during 1973 and is 1 percent more than was indicated in the fall Commerce survey (see Chart I). Even more bullish estimates of capital spending in 1974 were obtained from surveys, taken at about the same time, by Lionel D. Edie and McGraw-Hill. These surveys revealed a roughly 19 percent increase in capital outlays planned for 1974. The differences between the results of these surveys may be accounted for by the fact that both the McGraw-Hill and Edie samples are weighted more heavily toward large firms than is the Commerce survey. In any event, the Edie and McGraw-Hill results constitute a substantial upward revision from their earlier estimates of a 12 percent to 14 percent increase in capital spending during 1974. On balance, these figures suggest that the energy shortage has had a positive effect on business fixed investment plans. The McGraw-Hill survey indicates a large increase in spending by the energy-supplying industries. The petroleum industry expects to double its expenditures relative to the increase planned earlier, while the electric utilities have plans to increase capital spending 18 percent, up from the 14 percent rise reported earlier. On the other hand, many energy-consuming industries have pared their spending plans. Both the auto industry and the trucking companies have substantially scaled back their capital spending plans for 1974.



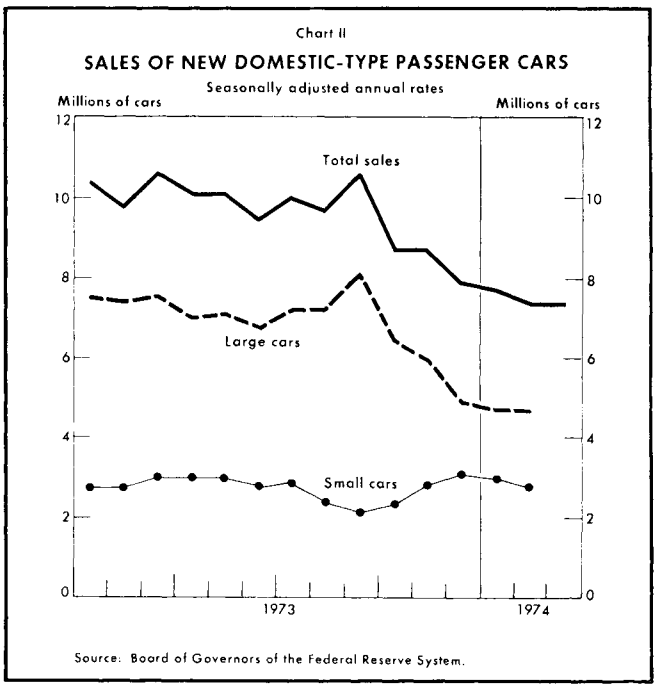
PERSONAL INCOME, CONSUMER DEMAND, AND RESIDENTIAL CONSTRUCTION

Personal income advanced $6.6 billion in February to a seasonally adjusted annual rate of $1,093.6 billion. Even though this rise is rather modest when compared with the average monthly gain of $8.8 billion in 1973, it does represent a rebound from the $2 billion drop in January. About half of the February advance was concen-

trated in private wage and salary disbursements, which rose $3.2 billion largely as a result of increases in payroll employment, the average workweek, and hourly earnings. In comparison, wages and salaries had fallen $1.7 billion the month before. However, wage and salary payments in the manufacturing sector remained unchanged in February, after declining by $2.1 billion in January. Energy-induced layoffs pared the number of workers on factory payrolls in both January and February, but the sharp January drop in the length of the manufacturing workweek was followed by a substantial rebound in February.

Consumer spending remains on the sluggish side. According to the revised estimate for February, total retail sales edged up only 0.2 percent above the January level. As in recent months, declining purchases at retail automotive outlets restrained the growth of retail sales. When the automotive group is excluded from the total, retail sales rose more than 1 percent above the January figure. However, measured in current-dollar terms, total retail sales in February remained below the peak reached last October and, when stripped of price increases, they were probably at their lowest level since late 1972.

Following three consecutive monthly declines, sales of new domestic-type passenger cars held steady in March at a seasonally adjusted annual rate of 7.4 million units (see Chart II), suggesting that perhaps the weakness in auto sales has bottomed out. The significance of the March figures is somewhat difficult to assess, however, because intense sales contests were reportedly under way during the month. The persistent decline in auto sales prior to March was largely the result of the slump in purchases of standard-size models. Large car sales fell from a peak seasonally adjusted annual rate of 8.1 million units in September to 4.7 million units in February. Much, but not all, of this decline can be traced to the Arab oil embargo and the associated uncertainties, particularly with respect to the cost and availability of gasoline. It is, of course, too early to determine whether the lifting of the embargo will stimulate sales of large cars or if a more permanent change in consumer preferences has taken place. Meanwhile, the demand for small domestic-type cars has remained buoyant. Sales of such models rose from a seasonally adjusted annual rate of 2.1 million units in September to a peak of 3.1 million units in December; such sales totaled 2.7 million units in February. According to industry observers, small car sales would have been considerably higher in recent months if supply had been able to keep up with demand. By way of perspective, the share of small cars as a percentage of domestic auto sales has risen markedly from an average of 27 percent over the first three quarters of 1973 to a peak of 39 percent in December and January and 36 percent in February of this year. Over the same period, the share of total new car sales accounted for by imports, which are mostly small cars, has also increased.



Residential construction activity showed further signs of strengthening in February, but the duration and magnitude of this rebound are highly uncertain. Housing starts rose in February for the second successive month, climbing 22 percent to a seasonally adjusted annual rate of 1.8 million units; hence, starts have risen well above their recent low of 1.4 million units posted last December. However, the size of the February increase—the largest one-month percentage rise on record—may be somewhat of a statistical quirk. In contrast to the sharp spurt in starts, newly issued building permits remained essentially unchanged in February at a seasonally adjusted annual rate of 1.3 million units, a little more than 5 percent above the depressed rate reached last December.

Deliveries of mobile homes edged up slightly in January to a seasonally adjusted annual rate of 469,000 units, but they remain more than a third below the record pace reached early in 1973. Sales of new single-family homes picked up a bit in January, too, after declining sharply in the previous month. At the same time, inventories of unsold homes have remained virtually unchanged. Conse-

quently, the ratio of unsold homes to sales declined slightly from the record 12.2 months of sales posted in December to a still high 11.8 months of sales in January. Substantial quantities of unsold homes may serve to restrain construction in the future. Moreover, with market rates of interest increasing considerably, the availability of mortgage funds at thrift institutions may become scarce once again.

PRICE DEVELOPMENTS

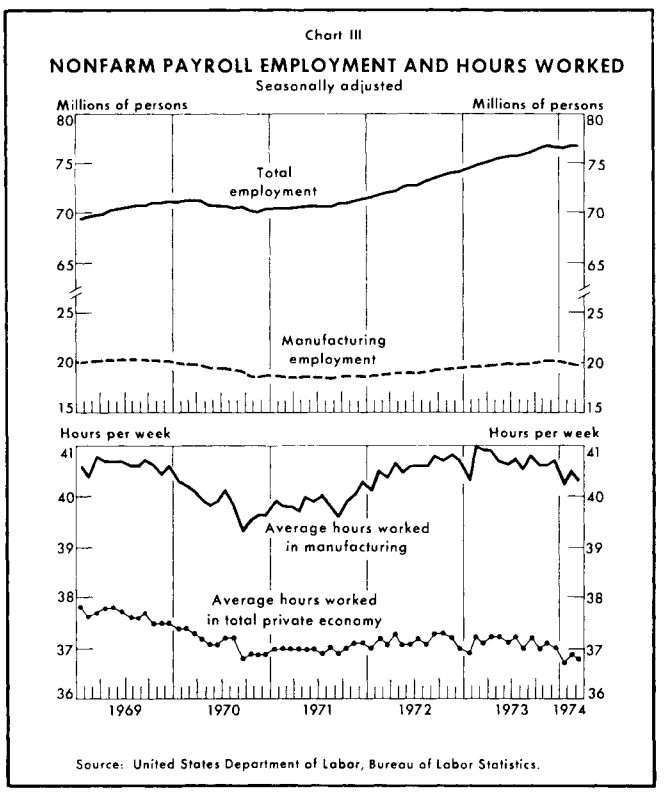
The latest data indicate that prices continue to rise at extraordinarily rapid rates. Although wholesale agricultural prices registered a fairly broad-based decline during March, some observers fear this development could be reversed in coming months. Moreover, the extreme volatility exhibited during the past year or so by agricultural prices makes it difficult to assess the significance of month-to-month changes in such prices. Energy prices have tended to dominate the behavior of the industrial component of wholesale prices in recent months. During March, wholesale power and fuel prices soared at an annual rate of 58 percent, bringing the rise over the past half year to an astounding 121 percent at an annual rate. Even more disturbing, however, is the behavior of nonenergy industrial prices. Excluding power and fuel, wholesale industrial prices climbed more than 30 percent at an annual rate in March, the largest one-month burst on record, compared with a rise of 14 percent over the span of the preceding four months and an advance of 7½ percent over the year ended last October.

Consumer prices surged at a seasonally adjusted annual rate of 15½ percent in February, the second largest monthly increase since the Korean war. Moreover, the increase in consumer prices over the year ended in February equaled 10 percent, the most rapid annual increase in consumer prices in more than twenty-five years. As in recent months, the jump in consumer prices in February was led by rising food and energy prices. Food prices climbed at more than a 30 percent seasonally adjusted annual rate in February. Such prices had been anticipated to rise very rapidly during the early part of 1974, but the February advance was probably exacerbated by the independent truckers' strike which reduced supplies of foodstuffs in some areas of the country during the first half of the month. Consumer power and fuel prices also continued to soar in February, rising at a 51 percent seasonally adjusted annual rate. Prices of gasoline and motor oil led the surge. Since the start of the embargo last October, retail gasoline prices alone have risen at an annual rate in excess of 100 percent.

THE LABOR MARKET

After rising from the 3½-year low of 4.6 percent reached last October to 5.2 percent in January and February, the seasonally adjusted unemployment rate slipped to 5.1 percent in March, according to the monthly household survey. During March, the number of unemployed persons averaged 4.6 million, a half-million higher than the level reached in October. The civilian labor force was essentially unchanged in March for the second consecutive month at 90.5 million persons, following the very sharp rise recorded in January. While monthly and even quarterly changes in the size of the labor force tend to be quite volatile, the labor force has grown very rapidly during the past year or so. Over the four quarters ended in March, the labor force grew by 2.9 million persons, or 3.3 percent. This is much faster than the 1.8 percent increase in the size of the noninstitutional working age population.

The Labor Department survey of establishments revealed that the number of persons on nonagricultural payrolls declined by 125,000 in March. After falling in January and rising in February, nonfarm payroll employ-



ment in March stood at about the same level as in November and December of last year (see Chart III). Manufacturing employment has fallen steadily over the past few months and by March was 315,000 persons below the peak reached last November. A further decline in employment in the transportation equipment industry accounted for almost half the March drop in overall factory employment and brought to 200,000 the cumulative employment decline in this sector since November.

There is little doubt that the energy shortage has exerted a substantial adverse impact on unemployment in recent months. The Bureau of Labor Statistics compiles information on the distribution of the unemployed by reason of joblessness. These data indicate that all of the increase in joblessness since October has been among persons who lost their last jobs. The number of people unemployed because they had either left their last job or were new entrants or reentrants into the labor force has not changed appreciably over the past five months. There are some signs, however, that these adverse employment effects may be diminishing. For example, the Labor Department reported that the number of initial claims for unemployment compensation attributable to the energy shortfall under state insurance programs reached a peak of 115,000 during the first full week of February, but slackened to about 45,000 toward the end of March.

The Business Situation

Economic activity posted a sizable decline during the first quarter of 1974, as real gross national product (GNP) fell at a 5.8 percent seasonally adjusted annual rate, the largest quarterly decline since 1958. However, it appears that practically all of this drop reflected the impact of the Arab oil embargo which ended in mid-March. Moreover, the data suggest that the weakness in business activity did not spread widely throughout the economy but was confined largely to the automotive sector, which bore the brunt of the embargo's direct and indirect effects. During the first quarter, the decline in real gross auto product accounted for 95 percent of the drop in total real GNP. Subsequently, auto sales have apparently bottomed out and may even be on an uptrend. In addition, automobile producers have revised upward, by better than 4 percent, their second-quarter production schedules in response to the improved outlook.

On the other hand, the price situation has deteriorated even further in recent months. During the first quarter, the GNP deflator, which is the broadest available measure of price movements, soared at a 10.8 percent annual rate, the fastest climb since the Korean war, and the fixed-weight price index for GNP increased at an even more rapid rate. While skyrocketing food and fuel prices have had a very substantial impact on price data, the upward march of prices is currently taking place along a very broad front. Consumer prices rose at nearly a 13 percent rate in March, the third consecutive month of inflation in excess of 10 percent at the retail level.

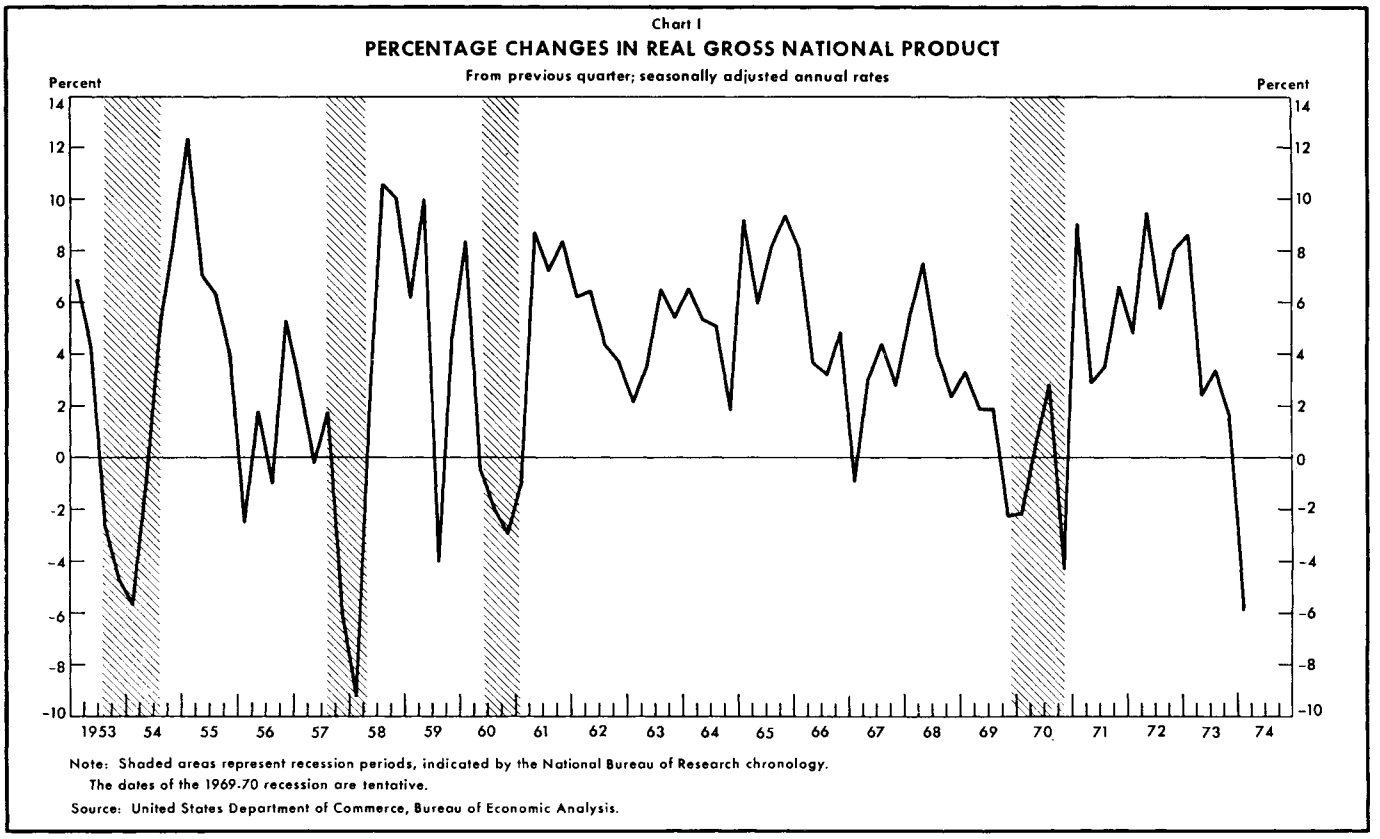
The first-quarter rise in compensation per hour of work was modest in comparison with the surge in consumer prices. As a result, real wages declined for the fourth consecutive quarter. Moreover, the decline in real wages experienced over the year ended in March is bound to escalate wage demands during the latter part of the year unless labor shows remarkable restraint.

GNP AND RELATED DEVELOPMENTS

Preliminary estimates indicate that the seasonally adjusted market value of the nation's output of goods and services rose only $14.3 billion at an annual rate during the first quarter of 1974. This constitutes a 4.4 percent annual rate of increase, the smallest percentage advance in nominal GNP in about three years. Moreover, when adjusted for the enormous rise in prices that occurred during the quarter, GNP actually declined at a 5.8 percent annual rate, the largest drop in real output since the first quarter of 1958. Reflecting the impact of pervasive shortages, the growth of real GNP had slowed noticeably during the two middle quarters of 1973, well in advance of the start of the Arab oil embargo (see Chart I). While the embargo had some effect on GNP during the fourth quarter of last year, its major impact was experienced during the first quarter of this year. The embargo weighed most heavily on the automotive sector. The reduction in gross auto product, which is the portion of GNP directly attributable to the production and sale of passenger cars, represented 95 percent of the overall decline in real GNP during the first quarter. Furthermore, real farm output decreased considerably during the first quarter after rising sharply in the October-December period. Excluding both the auto and farm sectors, real GNP edged down by less than 1 percent in the January-March interval.

A number of factors have probably helped to keep the economic decline precipitated by the oil embargo from spreading widely throughout the economy. A sizable portion of the impact to date has fallen on the automotive sector, where many workers have had their spendable incomes protected to a degree by supplementary unemployment benefit programs. Payments from privately sponsored plans, which have been incorporated into the collective bargaining contracts covering the rank and file workers at the major auto-producing firms, are combined with state unemployment insurance benefits to maintain temporarily take-home pay for eligible workers close to that earned on the production lines. More broadly, the persistence of the shortages which developed during 1973 has probably meant that some of the easing in demand that became apparent in certain sectors toward the end of last year and early in 1974 had relatively little impact on output and income.

The modest growth of nominal GNP in the first quarter



was accompanied by a sharp slowing in the rate of inventory accumulation (see Chart II). However, huge swings in dealer holdings of new passenger cars have obscured the extent to which inventory investment has strengthened in nonautomotive sectors. Excluding the change in dealer new car stocks, the rate of real inventory accumulation was actually somewhat stronger in the first quarter than during the previous three-month period. The change in overall business inventories, which dropped abruptly from the large $18 billion annual rate of accumulation registered during the fourth quarter to a $7.8 billion seasonally adjusted annual rate in the January-March 1974 period, does not of course reflect this. Further, while book value inventories posted very large gains during the first two months of the quarter, most of this was the result of price increases and is not included in the national income accounts estimate of inventory spending. The inventory valuation adjustment, which removes that part of the book value change due only to inflation, was huge in the first quarter.

The first-quarter increase in current-dollar final expenditures—that is, GNP net of inventory accumulation—amounted to a 7.7 percent increase at an annual rate, up from the pace of the previous quarter. In real terms, final sales actually declined at a 2.4 percent rate in the January-March period, a bit less than the 2.9 percent drop recorded over the preceding three-month interval.

Measured in current-dollar terms, consumer spending strengthened during the first quarter. Consumption rose $19.4 billion in the January-March interval, compared with the very small $9.2 billion increase of the preceding quarter. In real terms, however, consumer spending declined for the second successive quarter, although the decrease was noticeably smaller than that of the fourth quarter.

Current-dollar spending on consumer durables, which had declined by a sustantial $7.2 billion in the fourth quarter, fell an additional $1.1 billion in the first quarter of 1974. While this latest decrease continued to reflect weakness in spending on automobiles, there are tentative signs that the decline in auto sales may have bottomed out and

perhaps even reversed itself. Sales of new domestic-type passenger cars reached a three-year low of 7.4 million units (seasonally adjusted annual rate) in February, remained at that pace in March, but rose to 7.8 million units in April. The more favorable automobile sales picture can be attributed, at least in part, to the increased availability of gasoline as well as to the general improvement in the fuel outlook that has accompanied the announced termination of the oil embargo.

Consumer spending on nondurable goods picked up in current-dollar terms during the first quarter, with large increases in outlays for food, beverages, clothing, and shoes. After adjustment for price increases, however, spending on nondurables edged down. At the same time, real expenditures for services showed no change, the first quarter in twenty years that spending for services failed to expand in real terms.

During the first quarter, the rate of personal saving out of disposable income dropped sharply to 6.5 percent, after climbing from 5.7 percent to 7.3 percent in the last half of 1973. This decline in the personal saving rate may reflect attempts on the part of consumers to preserve consumption levels in the face of the diminution in real personal disposable income. Real disposable income fell in the January-March quarter for the first time since the fourth quarter of 1970. With declines in payroll employment and the average workweek during the first quarter, wage and salary disbursements grew slowly in nominal terms and dropped considerably after adjustment for the upsurge in consumer prices. Higher social security taxes resulting from the increase in the taxable wage and salary base also contributed to the fall in after-tax personal income.

Business fixed investment, an area expected to contribute substantial strength to the economy in 1974, advanced only modestly in the first quarter. The gain of $2.6 billion was the smallest in more than a year and, in real terms, first-quarter fixed investment experienced a slight decline. All of the most recent rise in nominal outlays for fixed investment was in stuctures; the leveling-off of spending on durable equipment may reflect the impact of capacity constraints and shortages on the capital goods industries. Backlogs of unfilled orders on the books of nondefense capital goods producers have grown at about a 30 percent annual rate over the first three months of this year. Furthermore, the latest McGraw-Hill survey of capital spending intentions reveals that businesses are still planning a large increase in such spending in 1974. In addition, most of the first-quarter slowdown in business fixed investment reflects the decline in business purchases of passenger cars and trucks. This decline is at least partly in response to the energy situation.

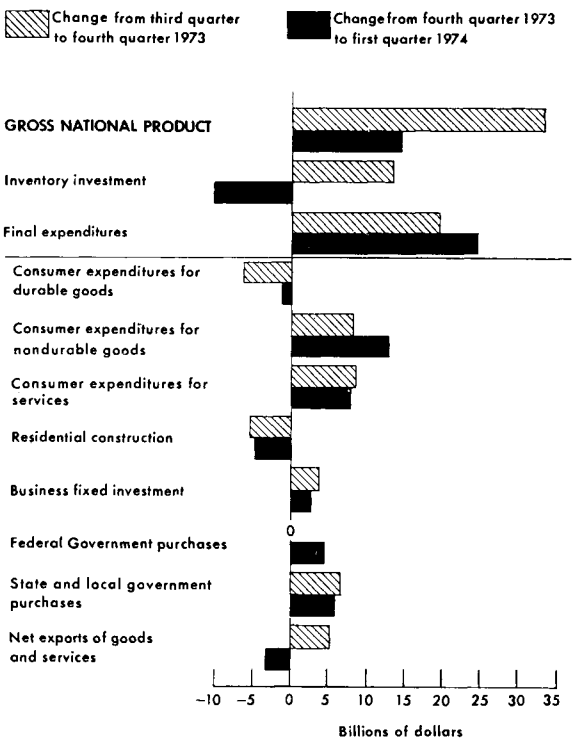
During the first quarter, residential construction spending dropped $4.5 billion. Since the peak reached in the January-March quarter of 1973, expenditures on residential structures have fallen almost $10 billion in current dollars and more than 20 percent in real terms. Seasonally adjusted housing starts dropped in March to 1.46 million units at an annual rate, the same as the January pace, suggesting that the sharp rise in starts in February was largely a statistical aberration. Permits for new construction, on the other hand, rose smoothly during the first quarter and, by March, had climbed 15 percent above the 3½-year low reached last December. However, the recent upswing in market interest rates and signs of renewed disintermediation at thrift institutions make the housing outlook highly uncertain.

Federal Government purchases of goods and services increased by $4.5 billion in the first quarter, reflecting gains

Chart II

RECENT CHANGES IN GROSS NATIONAL PRODUCT AND ITS COMPONENTS

Seasonally adjusted



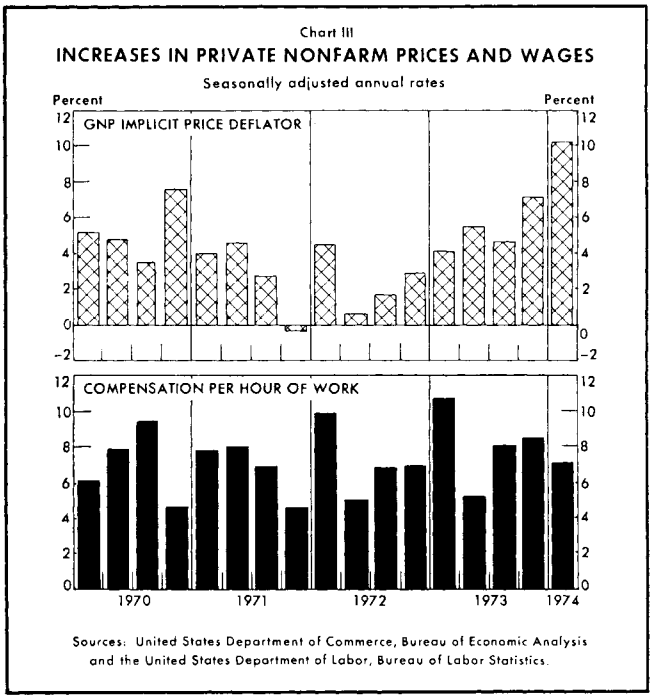
Source: United States Department of Commerce, Bureau of Economic Analysis.

of $3.2 billion in defense spending and $1.3 billion in nondefense outlays. At the same time, state and local government outlays rose $5.8 billion. During the January-March period, spending by all levels of government expanded to $296 billion, approximately 22 percent of total GNP.

PRICES

The price situation deteriorated further during the first quarter. According to preliminary data, the implicit GNP deflator rose at a 10.8 percent annual rate, 2 percentage points faster than in the fourth quarter of 1973 and the most rapid quarterly price increase in over two decades. Over the four quarters ended March 1974, the deflator climbed by an extraordinary 8½ percent. The severity of the acceleration in the rate of inflation is underscored by the fact that, during each of the preceding two years, the GNP deflator rose only about 3½ percent. A number of factors have contributed to the recent, sustained explosion in prices. Food prices continued to rise at extremely rapid rates through the first quarter. Nevertheless, the private nonfarm deflator still rose at a rate in excess of 10 percent in the same interval (see Chart III). The Arab oil embargo put very substantial upward pressure on prices of domestic energy supplies since they can serve, in varying degrees, as substitutes for imported fuels. Moreover, there is some indication that the process of gradually eliminating wage and price controls, which gathered momentum in recent months, may have contributed to the first quarter's distressing rate of inflation.

Consumer prices rose at a 12.9 percent seasonally adjusted annual rate in March, marking the third consecutive month of inflation in excess of 10 percent at the consumer level. During the three months ended in March, consumer prices increased at a spectacular 13.8 percent annual rate, on top of the already very rapid 9.4 percent increase during the last half of 1973. The March increase brought the consumer price index to a level of 10.2 percent above that of a year earlier, the largest yearly surge since 1948. Almost half of the February leap in consumer prices reflected steep increases in food prices, but the March jump was more broadly based. In March, consumer food prices increased at a 9.1 percent rate, substantially slower than the February climb of 30 percent. Skyrocketing energy prices have contributed heavily to the current bout of inflation. In March, consumer power and fuel prices rose at a 47 percent annual rate, bringing the climb during the first quarter to a 57 percent pace. Nevertheless, surging prices of food and energy-related items have obscured in recent months the inflationary pressures in other areas of the economy. For example, excluding food and consumer power and fuel, consumer prices still advanced at a 7.4 percent rate during the three months ended in March, compared with a 4.6 percent rise in 1973.



WAGES, PRODUCTIVITY, AND EMPLOYMENT

Although recent information indicates a moderate increase in wages in the first quarter, cost pressures nevertheless intensified. Compensation per hour of work—the broadest available measure of wages and benefits—rose at a 7.1 percent seasonally adjusted annual rate in the private nonfarm sector of the economy during the opening quarter of this year. Including the farm sector, the advance in compensation was somewhat slower. In any event, because of the rapid escalation in the rate of consumer price increases, real hourly compensation declined in the January-March period for the fourth consecutive quarter to reach a level 2½ percent below that of a year earlier. According to the separate survey of collective bargaining agreements covering 1,000 or more workers, contracts settled during the first quarter of the year provided, on average, for first-year wage and benefit gains of 6.9 percent and for improvements over the life of the contract of 5.9 percent. While seemingly on the modest side, it should be noted that these figures do not include

those payments made under escalator clauses contingent on movements in the consumer price index. About half the workers for whom major agreements were concluded during the first quarter had such clauses in their contracts. Moreover, the collective bargaining data for the first three months of the year encompassed only 466,000 of the more than 5 million workers covered by major contracts for which wages can be negotiated this year.

As measured by real output per hour of work, private nonfarm productivity declined at a 3.4 percent annual rate in the first quarter. This dip in productivity, coupled with the rise in compensation, resulted in an increase in private nonfarm unit labor costs during the period of 11.1 percent at an annual rate. Short-term movements in output per hour of work typically reflect variations in the rate of real economic growth. For example, over the four quarters ended in March 1973, real private nonfarm output rose a substantial 9 percent and productivity grew by a healthy 5.3 percent. During the next three quarters, when real output increased at a much slower 2.7 percent pace, output per hour of work actually edged down. The sharp productivity drop in the first quarter of this year, doubtless related to the Arab oil embargo, stems from the fact that the decrease in real output was considerably larger than the decline in hours worked. One possible reason for the disparity between the declines in output and hours is that firms were reluctant to make commensurate reductions in employment and hours in the face of what was viewed as a largely temporary situation.

After climbing from 4.6 percent last October to 5.2 percent in January, the unemployment rate subsequently steadied in February and then edged lower in the two succeeding months. The seasonally adjusted unemployment rate dropped to 5 percent in April, the same level that prevailed in the corresponding month last year. The recent declines in unemployment occurred largely as a result of contractions in the labor force amounting to 60,000 persons in March and a further 180,000 in April. It is important to note, however, that these reductions were preceded by sizable increases, so that the labor force was 2.3 percent larger in April 1974 than it was twelve months earlier. Over the two months ended in April, the teen-age labor force fell by 280,000 and the adult male work force by 247,000, but the adult female labor force jumped by 283,000 persons. While the modest decline in the unemployment rate was unexpected in light of the slowdown in business activity, it should be noted that the cyclically more meaningful unemployment rate for married men edged up in April, reaching a level last recorded in March 1970. Since November, the unemployment rate for married men has inched slowly upward.

In the April payroll survey of nonfarm establishments, seasonally adjusted employment increased by 126,000, bringing the rise since the end of 1973 to a total of 285,000. Manufacturing employment, which had fallen steadily since November, rose significantly and accounted for 75,000 of the April advance. About two thirds of the rise in manufacturing employment was centered in the transportation equipment sector, where recalls of automotive workers boosted employment during the month. Although there was a sharp drop in the average workweek and, particularly, in manufacturing overtime hours in April, this may largely reflect the fact that the Friday and Saturday preceding Easter, when many employees traditionally work reduced hours, were included in the survey week.

The Business Situation

Economic activity appears to have begun a recovery following the sharp energy-shortage-induced decline that marked the first quarter.* Industrial production expanded moderately in April, after having decreased over the previous four months. New orders for durable manufactured goods and retail sales both advanced in April, boosted by a resurgence in the demand for automobiles. At the same time, backlogs of unfilled durables orders continued to mount and, despite the sluggish first quarter, large increases in expenditures on plant and equipment appear to be in prospect for the year. However, these statistics have to be interpreted with some caution, as they are expressed in nominal terms and thus in part reflect the rapid rate of inflation. The one sector of the economy for which the outlook remains troubling is residential construction. The recent sharp runup in interest rates and the loss of deposits at thrift institutions threaten to prolong and, perhaps, deepen the housing slump. The Federal Government's newly announced measures to bolster housing may succeed in stabilizing housing activity at about current levels.

Price developments remained disturbing in April. While food prices declined during the month, most other prices continued to spurt ahead. At an annual rate, the increase in consumer nonfood prices topped 10 percent again in April and was about equal to the rate of increase over the previous six months. In the same month, wholesale industrial prices climbed at almost a 28 percent annual rate, this too being about equal to the average rate of increase of the past six months. Moreover, the price increases that have occurred since the last of the price controls were removed were not reflected in the April data. In the next few months, these post-controls increases are likely to maintain the rate of inflation at very high levels.

INDUSTRIAL PRODUCTION, ORDERS, AND INVENTORIES

In April, the Federal Reserve Board's index of industrial production rose at a 4.8 percent seasonally adjusted annual rate. In the four preceding months, total production had fallen at nearly an 8 percent annual rate, about 40 percent of which was directly attributable to the steep drop in automotive output. The April expansion in industrial output appeared to signal the end of the energy-shortage-induced declines of earlier months. Indeed, the production of motor vehicles and parts spurted at almost a 71 percent annual rate in April and accounted for almost two thirds of the rise in total output. Another healthy sign was the 9 percent growth in the production of iron and steel mill products. In contrast, during the December-to-March period, steel production had fallen sharply. Following the sizable decreases that had occurred since last October when the oil embargo began, total energy output remained virtually unchanged in April. Nevertheless, the gasoline situation has shown marked improvement. Whereas gasoline output had fallen over 45 percent at an annual rate from last October to January, it increased almost 30 percent from January to March.

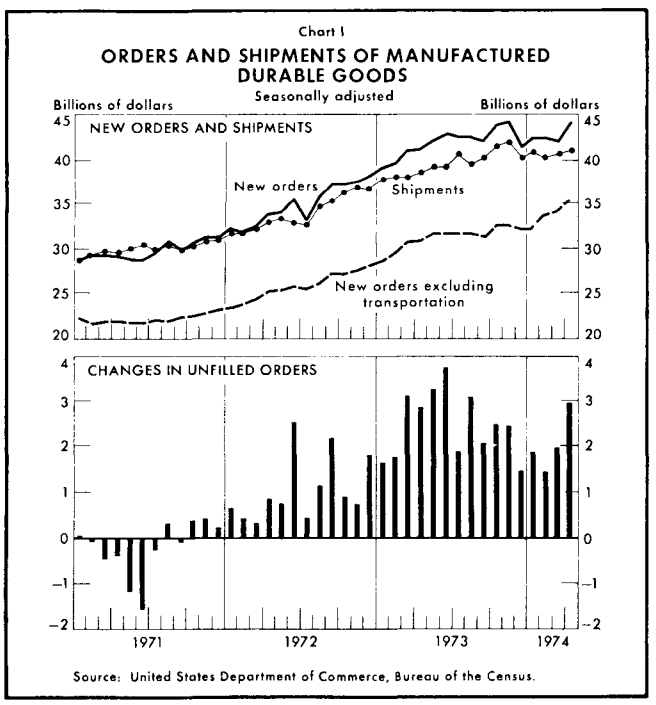
Activity in the automotive sector of the economy picked up somewhat in April. Both production and sales increased for the first time in many months, rising to the highest levels since last December. New car assemblies rose 13.6 percent in April to a seasonally adjusted annual rate of 7.5 million units. This was, nevertheless, well below the 10 million assemblies averaged during the first six months of 1973. New domestic car sales rose 5.4 percent in April to a seasonally adjusted annual rate of 7.8 million units. A renewed interest in full-size models was primarily responsible for this stepped-up sales activity. Although greater availability of gasoline undoubtedly spurred pur-

* The revised first-quarter estimates indicate that gross national product (GNP) increased by $14.7 billion to a seasonally adjusted annual rate of $1,352.2 billion. The rate of increase in the implicit GNP deflator was revised upward to 11.5 percent per annum, and the rate of decline in real GNP was revised downward to −6.3 percent. According to the preliminary estimates released along with the GNP revisions, before-tax corporate profits increased $12.7 billion in the first quarter.

chases to some extent, dealer sales contests probably were also a contributing factor. Meanwhile, it also appears that the automobile inventories of retail dealers have finally been brought into line with sales. Inventories totaled 1.49 million units at the end of April, down from the November peak of 1.84 million. Moreover, dealers appear to have achieved a better balance in the mix of inventories between large and small automobiles.

Seasonally adjusted new orders received by durable goods manufacturers posted a 4.9 percent, or $2.1 billion, gain in April (see Chart I). Large increases were recorded in orders for transportation equipment and for fabricated and primary metals, and these accounted for most of the overall advance. Despite the April rise, new orders for durable goods remained below the record levels attained late last year. However, in recent months, the behavior of this indicator has reflected the sharp reduction in the orders and shipments of automobile manufacturers. Excluding transportation equipment, new orders for durables have displayed a distinct upward trend throughout the year. As shipments were again below new orders in April, the backlog of unfilled durables orders mounted further.

The book value of manufacturers' inventories advanced in April at a $23.2 billion annual rate. This rate of accumulation was about the same as that of the previous month, and it was only slightly below the $25.6 billion increase averaged in the December-to-February period. According to disaggregated data, the buildup in inventories in recent months has not been evenly distributed among industries nor among inventories at different stages of fabrication. This unevenness is quite apparent, for example, in the inventory-to-sales ratios for manufacturing. For nondurable goods industries, the inventory-sales ratio in April remained at the near-record low levels of earlier months of the year. In contrast, the inventory-sales ratio for durable goods industries climbed further in April, rising to the highest level in over a year. However, the inventory accumulation by durables manufacturers does not appear to have been produced involuntarily by lagging sales, as the rise in inventories of durable finished goods has been relatively modest. Rather, most of the buildup has been in purchased materials and supplies and in goods in process, especially in the machinery industries. In view of the continued expansion in new bookings of these capital goods industries, this pattern of inventory accumulation is more symptomatic of economic strength than of weakness.



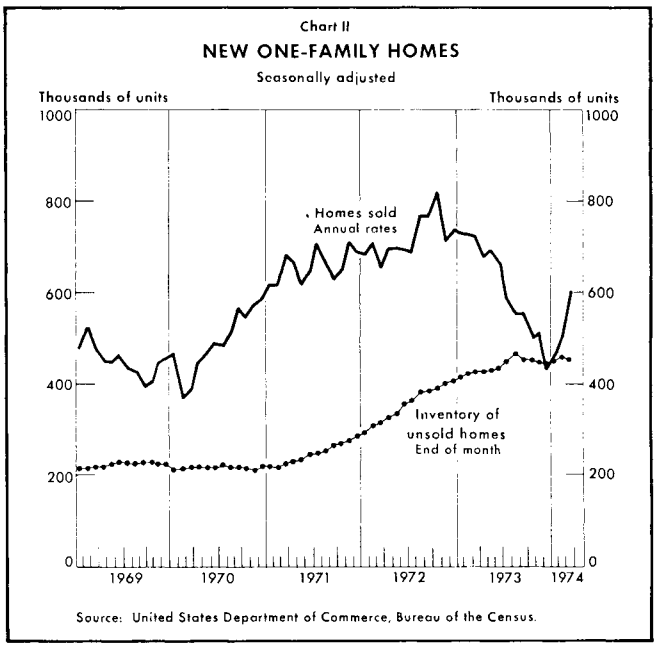
PERSONAL INCOME AND CONSUMER DEMAND

Seasonally adjusted personal income advanced at a $7 billion annual rate in April. Farm income fell, as agricultural prices continued to decline, but this was more than offset by the increased social security benefits which took effect during the month and by the gains in wage and salary disbursements. Indeed, about half the overall April advance stemmed from the rise in private wage and salary payments, with disbursements in the manufacturing sector increasing $1.3 billion following their sluggish behavior of the previous four months. This increase reflected not only the disproportionately large number of collective bargaining agreements reached during the month but also the renewed strength in manufacturing employment.

Retail sales turned in a strong performance in April, rising at a 16.9 percent seasonally adjusted annual rate. Most of the gain was attributable to increased automotive purchases, as sales of other goods edged up only slightly. However, over the three months ended in April, retail sales rose along a broad front; total retail sales climbed at a 13.8 percent annual rate over this period, and the increase was rather evenly distributed among automotive, other durable, and nondurable goods. For the year ended April 1974, the growth in current-dollar retail sales amounted to 7.8 percent, down from the 13.5 percent increase posted during the previous twelve-month

period. In view of the concomitant acceleration in consumer prices, the slowdown in retail spending was considerably greater in real terms.

The spurt in consumer prices, moreover, appears to have given rise to a shift in the composition of consumer spending. Evidently as a result of the sharply rising prices of food and energy, consumers have been devoting an increasingly smaller share of their budgets to purchases of durable goods, which tend to be postponable. In the event that the pace of inflation slows and other uncertainties in the economic situation fade, consumers may well return to their former spending patterns.



RESIDENTIAL CONSTRUCTION

The prospects for a full-fledged recovery in residential construction from its recent slump have begun to dim, despite some signs of temporary improvement. Private housing starts rose in April to a seasonally adjusted annual rate of 1.63 million units, up from the previous month but about equal to the average of the first three months of the year. Merchant builders' sales of new one-family homes rose steadily over the first quarter to a seasonally adjusted annual rate of 600,000 units in March, the latest month for which data are available (see Chart II). This sales rate was almost 40 percent above the depressed December level and was the highest since last June. However, the inventory of unsold homes remained near the record level attained last August. Moreover, the leveling-off in these inventories over the past six months conceals a shift in their composition that does not augur well for home building. Since August, the percentage of homes completed but not sold has increased from 22 percent to 29 percent of total inventories while the proportion of unsold homes not yet started—that is, where a permit has been issued but ground not broken—has fallen to the lowest level in about three years. Hence, there is a relatively large volume of completed but as yet unsold homes on the market. This may account for the lethargic behavior of newly issued building permits in recent months.

In the near term, the recent runup in market interest rates is likely to have a severely constricting effect on mortgage availability. Indeed, the higher interest rates appear to have given rise to a large outflow of deposits at New York State savings banks in April. In that month, too, deposits at savings and loan associations rose at a 4.9 percent seasonally adjusted annual rate, well below the 10.2 percent rise posted in the first quarter of the year. Some tightening in the mortgage market is already in evidence. For example, between mid-March and early May, the average yield on four-month commitments on Government-insured mortgages at auctions conducted by the Federal National Mortgage Association jumped more than 1 percentage point to 9.48 percent, establishing a new record.

With the slowing in thrift institution deposit flows, the Federal Home Loan Bank (FHLB) Board, in an attempt to encourage mortgage lending, has rescinded its previously announced increase in the proportion of liquid assets that savings and loan associations must maintain. In addition, the FHLB Board may soon act to allow savings and loan associations to issue negotiable large-denomination certificates of deposit (CDs). At present, savings and loan associations can issue only nonnegotiable CDs, which carry stiff penalties for early withdrawals. While this proposal, if implemented, will enable savings and loan associations to compete for funds, the impact on housing is far from certain, since usury ceilings in many states still may restrict mortgage lending. In those states without ceilings or with very high ceilings, potential home buyers may well balk at the high mortgage interest rates.

In addition to these FHLB Board actions, the Administration announced in early May that it would soon institute a new housing program. The program consists of an expansion of the "Tandem Plan" subsidies on Federal Housing Administration-Veterans Administration mortgages, further advances by the FHLBs to savings and loan

associations at bargain rates, and a new FHLB program allowing the Federal Home Loan Mortgage Corporation to purchase conventional mortgages at below-market rates. Together, these three actions could pump as much as $10.3 billion into the mortgage market. The extent to which this program will benefit the residential construction sector is in question, however. Thrift institutions will undoubtedly use only a portion of the $10.3 billion to extend new mortgages. The rest will be used in one way or another to offset current and near-term deposit withdrawals. Moreover, whatever proportion of the $10.3 billion is used to acquire new mortgages, some of these mortgages will doubtless cover new homes that are already built but not yet sold. While this would reduce the overhang of unsold new homes, builders may nevertheless be reluctant to begin constructing additional new units.

PRICES

Consumer prices, seasonally adjusted, rose in April at a 6.9 percent annual rate, the first time in four months that the rate of increase was below the 10 percent mark. However, the slowdown was almost entirely attributable to a 5.3 percent rate of decrease in consumer food prices, the largest drop in seven years. Prices of nonfood commodities, on the other hand, advanced in April at a 12.8 percent annual rate, a bit above the average increase of the previous six months. Evidently, the huge rise in wholesale industrial prices in recent months is being translated into increases at the consumer level. Once again, skyrocketing energy prices led the overall April rise, as prices of consumer power and fuel spurted ahead at a 24 percent annual rate.

At the wholesale level, prices of farm products and processed foods and feeds declined sharply in April for the second consecutive month. These prices dropped at an annual rate of nearly 36 percent in April. However, during the last year or so, monthly movements in wholesale farm prices have been quite erratic, registering extraordinarily large increases and decreases within the space of a few months. Furthermore, the April drop is attributable mainly to declining grain and livestock prices, and there are some indications that the fall in livestock prices may soon be reversed. Beef prices have declined in response to forces set in motion about six months ago, when large numbers of cattle were placed on feed. In recent months, the number of cattle placed on feed lots has fallen off dramatically.

In April, wholesale industrial prices shot ahead at a 27.8 percent seasonally adjusted annual rate. The advance in wholesale power and fuel prices slowed noticeably, but the increase in other wholesale industrial prices amounted to a disturbing 31.5 percent on an annual rate basis. By comparison, over the preceding three-month period these prices had risen at a 20.6 percent rate. The single most important factor behind the recent surge in wholesale industrial prices has been the soaring price of metals, particularly steel. This surge in wholesale industrial commodity prices is especially disconcerting, since additional price rises were announced as the final vestiges of wage and price controls were removed. These increases have not yet appeared in the major price indexes.

The Business Situation

While many business indicators have lately been distorted by the rocketing rate of inflation, it appears that a modest recovery in economic activity is under way. Industrial production advanced in May for the second consecutive month, following the sharp energy-related declines in the four preceding months. At the same time, new orders for durable manufactured goods rose, and the backlog of unfilled durables orders climbed further. An expansion in capital spending appears to be in prospect for coming months, especially in the manufacturing sector. On the other hand, consumer spending has remained noticeably weak. Constant-dollar retail sales have been essentially flat throughout the year, well below the peak level attained early in 1973. Residential construction has been plagued by higher interest rates, increasing costs and prices, declining new home sales, and a general unavailability of mortgage financing. Although the unemployment rate rose in May, it was largely the result of a large jump in the teen-age labor force following two months of unusual declines. In June, labor market conditions were essentially unchanged and the unemployment rate held steady at 5.2 percent of the civilian labor force.

Inflation remains severe in most sectors of the economy. At an annual rate, consumer nonfood prices spurted 15 percent in May, up slightly more than 3 percentage points from the rate of increase experienced in earlier months of the year. Also in May, a sharp acceleration occurred in the rate of advance of wholesale industrial prices, excluding power and fuel. In contrast, wholesale agricultural prices dropped for the third consecutive month. To the extent that some of these increases reflect the termination of price controls, the pace of inflation should moderate in coming months. However, the degree of moderation is likely to be limited as a result of the concurrent buildup of cost pressures on prices. While there are indications that at least some raw materials prices are receding from recent peaks, it is too early to conclude what effect this might have on finished product prices. Furthermore, the failure of declines in food prices at the wholesale level to affect retail food prices significantly is a matter of concern.

INDUSTRIAL PRODUCTION, ORDERS, AND INVENTORIES

On a seasonally adjusted basis, the Federal Reserve Board's index of industrial production rose in May at a 4.8 percent annual rate, its second consecutive monthly advance. Nevertheless, the index in May remained 1.6 percent below last November's peak. The overall May advance was concentrated in the output of consumer goods and business equipment. Total energy production increased in May, and gasoline output surpassed its preembargo level. The production of basic materials was unchanged. However, there appears to have been some easing lately in the very tight supply conditions that had prevailed in many basic raw materials industries through much of last year. The Federal Reserve Board's index of capacity utilization in major materials industries has declined for two successive quarters following the record high level reached in the third quarter of 1973. Moreover, according to the National Association of Purchasing Management's survey, the percentage of respondents reporting forward commitments of sixty days or longer to buy production materials has declined noticeably since February. Despite the easing, some materials are still in short supply.

The automotive sector has displayed signs of a modest further recovery in recent months. In May, new car assemblies rose to a seasonally adjusted annual rate of 7.7 million units, the highest thus far this year but nearly 25 percent below the pace of a year ago. Sales of new domestic models increased slightly in June to an annual rate of 8 million units, up about 5 percent from the rate of sales averaged in the first quarter of the year. Increased sales of full-size models accounted for virtually all of the

improved performance of the past several months, as the market share of small models declined to about one third of total sales.

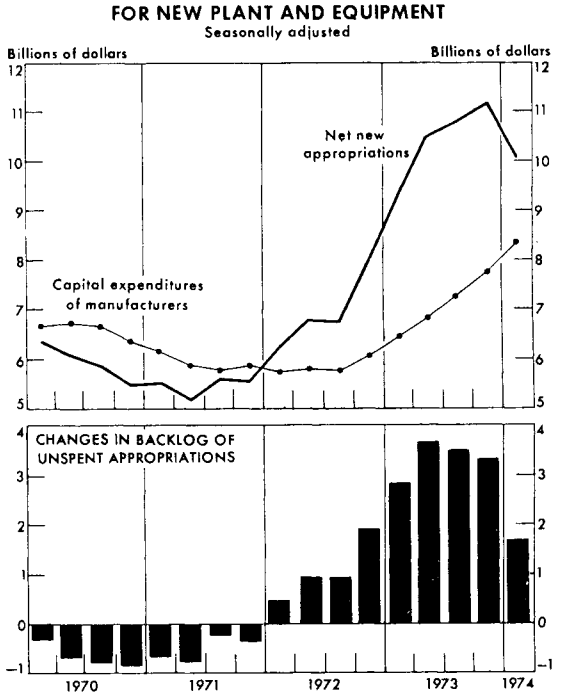
Led by the large advance in new bookings for primary metals, the seasonally adjusted flow of new orders placed with durable goods manufacturers surged 5.9 percent in May. Coupled with the large increase of the preceding month, the May rise advanced new durables orders above the high level that had prevailed late last year. The April and May gains, moreover, exceeded the price hikes recorded for manufactured durable goods in those months. Shipments of durables also rose in May, but they remained below new orders, and the backlog of unfilled orders mounted further. While in recent months the accelerating rate of inflation has boosted the growth rate in the backlog of unfilled orders, an uptrend is still in evidence when unfilled orders are measured in constant-dollar terms.

The book value of manufacturing inventories rose significantly in May, advancing at a seasonally adjusted annual rate of close to $28 billion. This represents a substantial increase over the gain of the previous month and is somewhat more than the $25.6 billion increase averaged in the December-to-February period. However, since manufacturers' shipments have kept pace, the inventory-sales ratio in this sector has remained virtually unchanged at 1.62 for four consecutive months. As a consequence of inflation, the inventory figures are somewhat difficult to interpret. It does not appear, however, that a substantial amount of undesired inventory accumulation has been camouflaged because of price movements. Less than 15 percent of the May rise in manufacturing inventories was attributable to increased stocks of finished goods. The remainder was the result of increases in stocks of purchased materials and work in progress. Apart from the buildup of purchased materials and work in progress in capital goods industries, which reflect the continued expansion in new bookings, the buildup of nonfinished goods inventories over the last several months may be a consequence of the shortages which depleted buffer materials stocks during 1973. In the aftermath, firms were induced to accumulate material inventories.

Chart I

MANUFACTURERS' EXPENDITURES AND APPROPRIATIONS FOR NEW PLANT AND EQUIPMENT

Seasonally adjusted



Source: The Conference Board, Inc.

CAPITAL SPENDING

According to the survey taken by the Commerce Department in April and May, total business outlays for new plant and equipment are now expected to rise 12.2 percent in nominal terms in 1974, only slightly below the 13 percent gain foreseen in the Commerce Department's survey taken three months earlier. The downward revision was in expenditure plans for the second half of the year and was centered in nonmanufacturing industries, particularly electric and gas utilities, mining, and communications. In contrast, for manufacturing industries, the planned 19.8 percent increase for 1974 outlays on new plant and equipment is slightly higher than the figure reported three months earlier. Moreover, within the manufacturing sector, major material-producing industries reported relatively large increases in intended outlays, much of which will go toward expanding current capacity.

In a separate survey conducted earlier by the Conference Board, net new appropriations for capital goods by the nation's 1,000 largest manufacturing firms declined almost 10 percent in the first quarter on a seasonally adjusted basis (see Chart I). Most of this decrease was attributed to an extraordinarily large increase in project cancellations by the automotive industry, which was then enshrouded by the uncertainties of the energy shortage; it was anticipated that many of these canceled projects would be reinstated in subsequent quarters. In any event, the backlog of unspent appropriations swelled further, rising by 4.6 percent over the quarter. At a record $38.3

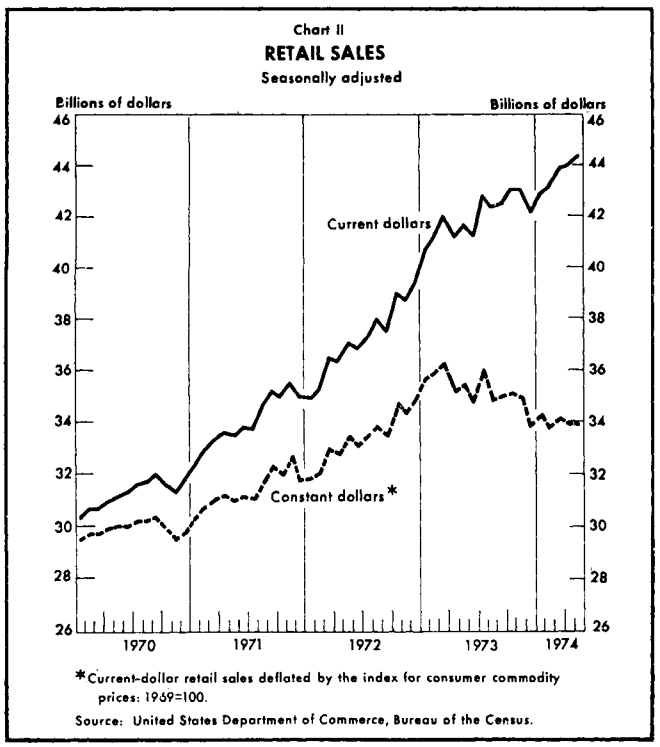
billion in the first quarter, unspent appropriations were almost 50 percent higher than a year earlier. Judging by past experience, most of these unspent funds will be translated into actual expenditures, and this augurs for a sizable increase in capital expenditures by manufacturers over the near term.

PERSONAL INCOME AND CONSUMER DEMAND

While the expansion in personal income picked up over the April-May period, constant-dollar retail sales remained weak. Personal income advanced at a $10.6 billion seasonally adjusted annual rate in May, the biggest rise since last November. Farm income fell for the fifth consecutive month as agricultural prices continued to decline. This was more than offset by the large $7.8 billion gain in wage and salary disbursements in the private sector, of which about $2 billion stemmed from the expanded coverage and higher minimum wage rate of the newly instituted minimum wage law. Increases in manufacturing employment and an acceleration in average hourly earnings boosted wage and salary disbursements in manufacturing by $3.1 billion, the largest hike in over two years.

In May, seasonally adjusted retail sales rose $425 million, an 11.6 percent annual rate gain. Sales of both automotive and other durable goods were up noticeably in current-dollar terms, while nondurables sales inched ahead. Over the first five months of the year, retail sales of nonautomotive durable goods climbed at almost a 20 percent annual rate, while gains in the automotive and nondurables categories were more moderate. Although automotive retail sales, which include purchases of both new and used cars, have rebounded from the February low, in May they were still 7 percent below last year's average monthly sales.

When the retail sales figures are adjusted for recent price hikes, consumer spending appears to have been decidedly weak of late (see Chart II). Indeed, measured in terms of the consumer commodity prices that prevailed in 1969, constant-dollar retail sales not only declined in May but were lower than at the start of the year. This decline, moreover, has been widely based, encompassing automotive, other durables, and nondurables purchases. Over the past year and a half, there has also occurred a relatively large drop in real income, although the extent of the decrease is difficult to measure. In any event, it seems clear that the erosion in real income has had a deleterious impact on the rate of real consumer spending.

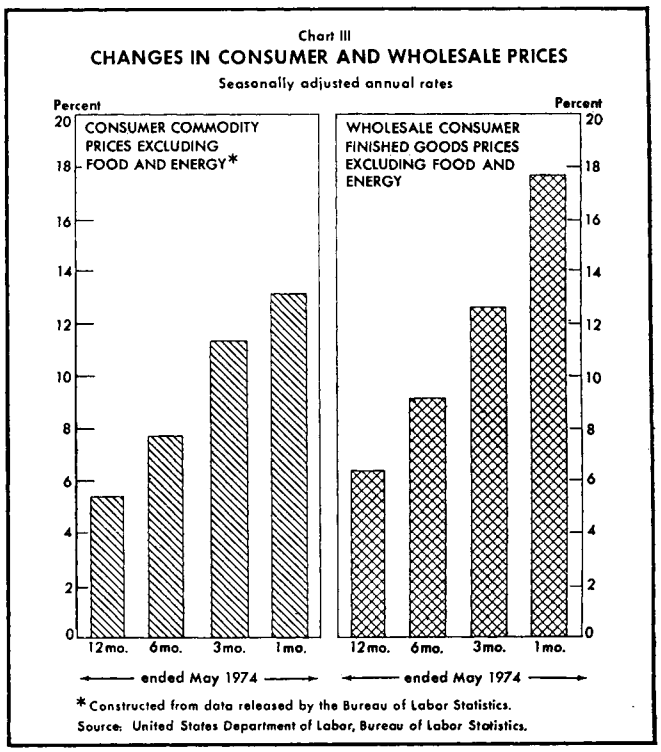


RESIDENTIAL CONSTRUCTION

Reflecting very tight mortgage market conditions, the residential housing situation continued to deteriorate in May. Private housing starts dropped precipitously, falling 11 percent to a seasonally adjusted annual rate of 1.45 million units. New building permits also fell almost 19 percent to 1.06 million units, the lowest total since April 1967. Continuing the pattern which emerged late last year, the May decline in housing starts was largely attributable to the steep drop in new construction of multifamily units. In recent years, real estate investment trusts have emerged as important lenders for multifamily unit construction. No doubt the difficulties they have had of late in issuing stock and tapping other sources of funds has contributed to the scarcity of financing for multifamily units.

The run-up in interest rates during the last several months has severely restricted the availability of mortgage money. Seasonally adjusted deposit growth of thrift institutions slowed to 1 percent at an annual rate in May, in contrast to the 7.3 percent growth rate during the first four months of the year. At the Federal National Mortgage Association's auction on July 2, the secondary market interest rates on four-month forward commitments for insured and conventional mortgages were in excess of 9.6 percent. The Federal Home Loan Bank Board's effective interest

rate on new home conventional mortgages climbed to a new record in May. For potential home buyers, the cost of mortgage financing has risen further. Reportedly, commitments on conventional mortgages are now being negotiated at contract rates slightly in excess of 9 percent.



LABOR MARKET

According to the household survey, the civilian labor force grew by 366,000 persons in May. This was more than enough to offset the largest gain in total civilian employment of the past six months. Consequently, the overall unemployment rate went up 0.2 percentage point in May to 5.2 percent on a seasonally adjusted basis. The May increase in the number of jobless workers looking for employment was more than accounted for by the additional 199,000 teen-agers who were unemployed. Labor market conditions were little changed in June, as the unemployment rate held steady and the age-sex composition of unemployment remained essentially unaltered. Total civilian employment increased by 194,000 workers in June, matching the May gain.

Some peculiarities in the household survey seem to have reversed themselves in the May data. It had been expected that an economic slowdown would result in higher joblessness particularly among secondary workers, most of whom are women and teen-agers. These expectations were not borne out by the data for earlier months. However, in May, both the teen-age and adult female unemployment rates rose from their low April levels, while the adult male unemployment rate fell to 3.4 percent. In addition, the adult male civilian labor force increased by a substantial 162,000 workers, reversing the declines that had occurred in the two previous months.

Seasonally adjusted payroll employment rose by a healthy 214,000 in May but subsequently declined by about 50,000 workers in June. The May rise was largely the result of big gains in government and services employment. To some extent, increased strike activity in contract construction may have contributed to the June decline in payroll employment. While the results of the household and payroll surveys diverged considerably in June, this frequently occurs because of differences in coverage, sampling techniques, and seasonal patterns. The surveys tend to show comparable changes over somewhat longer periods of time.

Taking a somewhat broader perspective, it is noteworthy that neither the unemployment rate nor the growth rate of employment since last November has been as severely affected by the recent economic slowdown as during the first six months of the 1960-61 and 1969-70 recessions. Much of the first-quarter decline in real output was centered in the automotive sector, where labor productivity is relatively high. Consequently, with so many automotive workers laid off in the early months of the year, a small increase in unemployment was accompanied by a large decline in real output. Moreover, to the extent that the slowdown was the result of materials shortages rather than slack demand, employers were probably more reluctant to lay off workers than they would otherwise have been.

The latest wage data point toward an acceleration in the rate of growth of hourly earnings. On a seasonally adjusted basis, 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, increased in June at a 12.3 percent annual rate. This was equal to the May advance but was well above the rate of increase in earnings experienced over the preceding six months. Especially large increases in hourly earnings were recorded in June for workers in the manufacturing, finance, and construction sectors. In part, these hikes doubtless reflected the termination of wage controls. In the months ahead, the increases in contract settlements and in hourly

wage rates are likely to remain substantial, as workers attempt to keep pace with the rate of inflation as well as to make up for previous declines in real earnings over the past year or so.

PRICES

Inflation remains severe in most sectors of the economy, though lately there has been some retrenchment in food prices at the wholesale level. In line with previous expectations, the rates of increase in consumer and wholesale nonfood prices both accelerated in May, reflecting in part the price hikes that many firms instituted when the price controls program was terminated on May 1.

Consumer prices, seasonally adjusted, resumed their explosive advance in May, surging ahead at a 12.7 percent annual rate. A disturbing feature of the May increase was its pervasiveness. Consumer food prices posted a fairly large rise, more than erasing the previous month's drop. Consumer nonfood commodity prices jumped 15.3 percent in May, almost double the rate of advance of the previous twelve months. The recent acceleration in these prices is undoubtedly the result of the concurrent run-up in wholesale consumer finished goods prices (see Chart III).

At the wholesale level, prices rose at a 15.5 percent seasonally adjusted annual rate in May. Higher industrial wholesale prices wholly accounted for the overall advance, as the prices of farm products and of processed foods and feed posted another sharp decline. Wholesale power and fuel prices decelerated further in May, though their rate of increase still topped 30 percent. Excluding power and fuel prices, industrial prices surged at a 32.5 percent annual rate in May, up from the 25 percent rate recorded during the previous three months. The May spurt reflected both the response of firms to the removal of the price controls and the pass-through of current and previous increases in energy and materials prices. In May, prices of nonfood raw materials declined sharply, the first decrease in two years, but prices of intermediate nonfood materials and supplies jumped considerably.

The Business Situation

Economic activity was sluggish in the second quarter, and uncertainties over the possible implications of inflation, high interest rates, and liquidity problems remain. Real gross national product (GNP) declined at a 1.2 percent seasonally adjusted annual rate, following the sharp 7 percent decline registered in the first quarter. After allowing for the effect of higher prices, disposable income declined further in the second quarter but real personal consumption expenditures increased slightly, led by the rebound in spending on services and durable goods. At the same time, however, consumer confidence apparently remained weak and purchases of nondurables slowed. Plagued by tight mortgage markets and high interest rates, real spending on new housing continued to decline, but at a significantly slower rate than in the previous six months. In constant-dollar terms, business fixed investment was roughly unchanged in the April-June period. However, the backlog of unfilled orders of durable goods manufacturers grew substantially. One of the most important factors retarding real growth in the second quarter as relates to GNP accounting was the oil-related deterioration of net exports. In July, the labor market was essentially unchanged, although the unemployment rate edged up to 5.3 percent from the 5.2 percent rate of the previous two months.

Inflation continued at a dismaying rate in the second quarter, although the rate of increase slowed somewhat. According to preliminary Commerce Department estimates, the implicit GNP price deflator surged at an 8.8 percent annual rate in the second quarter, following the 12.3 percent advance of the first quarter of the year. The rate of increase in the fixed-weight price index—which, unlike the implicit deflator, is unaffected by changes in the composition of output—also slowed, but nevertheless the fixed-weight index climbed at an 11.2 percent annual rate in the second quarter, compared with a first-quarter advance of 12.7 percent. Over the past four quarters, the implicit deflator has increased 9.5 percent, the highest rate of increase in over twenty-five years. With at least part of this price explosion attributable to the dismantling of price controls, there is hope that the rate of inflation may moderate in coming months. However, much of the most recent slowing in the rate of increase has resulted from declines in prices of agricultural commodities—declines that now may be reversed as a result of reduced forecasts of future crop harvests. Furthermore, cost pressures on prices are not likely to ease in the near term in view of the recent huge expansion in the prices of wholesale industrial commodities and the strong demand for higher wages as workers attempt to regain their loss in purchasing power.

GROSS NATIONAL PRODUCT AND RELATED DEVELOPMENTS

Preliminary data released by the Commerce Department indicate that, measured in current dollars, the market value of the nation's output of goods and services rose at a 7.5 percent seasonally adjusted annual rate in the second quarter. After adjustment for price increases, however, real GNP declined slightly, falling at a 1.2 percent annual rate in the April-June period. At this time, the Commerce Department released its annual bench-mark revisions of GNP data going back to 1971. According to revised estimates, growth in the last quarter of 1973 was somewhat stronger than in the second or third quarters of that year, whereas earlier data had indicated some weakening. In addition, the decline in real GNP in the first quarter of this year is now estimated at a 7 percent rate (see Chart I), somewhat more than was first reported.

According to the preliminary estimates, business inventories rose $15.1 billion in the second quarter, slightly less than the $16.9 billion increase registered in the first three months of 1974. This slight decline in the rate of inventory accumulation followed a much sharper drop-off in the preceding quarter (see Chart II). For the last half of 1973 and the first quarter of 1974, Commerce Department revised estimates, which have on average doubled the original estimates of inventory spending, indicate that, measured in current dollars, inventory accumulation amounted to an average of $19.2 billion at an annual rate over these three quarters. Although a small part of the

most recent buildup has been in farm inventories, the bulk of the accumulation has been in stocks of nonfarm nondurable goods. The rate of increase in nondurable goods inventories doubled in the second quarter, rising to $16.5 billion at a seasonally adjusted annual rate from $8.2 billion in the first quarter. On the other hand, durable goods inventories fell $1.4 billion in the second quarter following an $8.7 billion dollar increase in the first quarter.

The growth of final expenditures—GNP net of inventory accumulation—remained essentially steady in the second quarter, as outlays climbed at a $26.5 billion rate compared with a $26.8 billion gain in the first quarter. After allowing for the impact of inflation, real final expenditures declined $1 billion in the April-June interval. Nevertheless, this was an improvement over the declines of $5.8 billion and $7 billion during the previous two quarters.

Personal consumption expenditures in current-dollar terms increased by $26.2 billion in the April-June period, well above the $16.7 billion increase posted in the first quarter and the $7.6 billion rise in the final quarter of 1973. Following two quarters of decline, real consumer spending registered its largest advance in over a year in the second quarter, paced by a rise in durable goods purchases. The outlook for consumer spending, however, continues to be complicated by the erosion of consumer confidence and purchasing power by inflation. The latest reading of the University of Michigan's index of consumer sentiment suggests little improvement in consumer confidence, although the index did edge up from the all-time low reached in February during the worst of the oil embargo. This survey indicated that an increasing number of consumers had become concerned over the pervasiveness of inflation.

Reversing the $0.4 billion decline in purchases of durables in the first quarter, consumer spending on durables increased $6.3 billion in the second quarter. After balking at purchasing automobiles in the January-March quarter, consumers renewed their purchases of autos, which accounted for more than one third of the increase in durables purchases. New automobile sales have gradually edged up from the 7.5 million units (seasonally adjusted annual rate) averaged in the first three months of the year to 7.9 million units in the second quarter, with 8 million units sold in

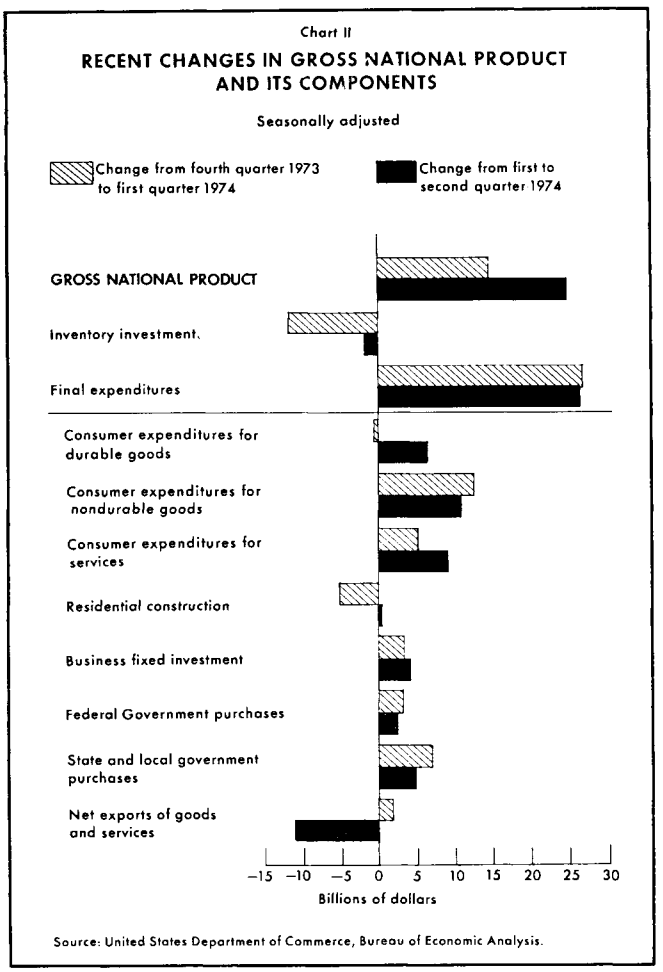
Chart I

PERCENTAGE CHANGES IN REAL GROSS NATIONAL PRODUCT

From previous quarter; seasonally adjusted annual rates

Note: Shaded areas represent recession periods, indicated by 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.



June. While part of the increase in automobile sales reflects the improved availability of gasoline, sales may also have been bolstered in the second quarter by expectations of still higher auto prices in the future. The latest Conference Board survey of consumers indicated a pickup in automobile buying plans.

The growth in consumer purchases of nondurable goods slowed in current-dollar terms in the second quarter, rising by $10.8 billion following a $12.3 billion increase in the first quarter. The increase in spending on food and beverages, clothing, and shoes all were smaller than in the January-March interval. After adjustment for price increases, real nondurables expenditures declined slightly in the second quarter.

The decline in the rate of personal saving out of disposable income accelerated in the second quarter. After climbing almost continuously from mid-1972, the saving rate dropped from an exceptionally high 9.5 percent in the fourth quarter of 1973 to 8.9 percent in the first quarter and to 7.6 percent in the second quarter. It appears that consumers are attempting to maintain their consumption levels despite a continuing decline in real disposable income. Real disposable income fell in the second quarter, but the decline was less than that posted in the first three months of the year.

Business fixed investment rose $4 billion in nominal terms in the second quarter, only modestly above the upward revised $3.3 billion gain recorded over the previous three months. While this sector has been counted on to provide a good portion of the upward thrust to the economy in 1974, some firms may be delaying or reducing capital spending projects in light of financial market conditions. Most notably, some public utility offerings have faced relatively poor receptions in the bond market and, as a result, this industry has pared planned capital expenditures. The latest Department of Commerce survey of planned expenditures indicated a 12.2 percent rise in outlays in 1974; however, since these outlays are in nominal terms, they reflect the rapid inflation rate and therefore overstate the level of real business spending. On the other hand, the persistent rise in the backlog of unfilled orders of durable goods manufacturers continues to suggest that gains in capital spending may be in the offing.

After declining for three consecutive quarters, residential construction spending rose modestly in nominal terms in the second quarter of 1974. Outlays increased by a slight $0.3 billion, a considerable improvement over the $5.2 billion decline in the first quarter of this year. As a result of the decline of its relative importance, residential construction outlays now account for only 3.1 percent of real GNP, the lowest percentage since 1970. Moreover, caught in the web of high mortgage rates and unavailability of mortgage money, the outlook for residential construction remains dim. The 8.1 percent annual rate increase in housing starts in June still leaves starts one-fourth below their level of a year ago. Multifamily starts have been particularly hard hit and now stand at 43 percent below the level of such starts a year ago. Part of this decline may be because of adverse publicity concerning condominium apartments and the recently announced Government investigation of possible unfair or deceptive industry practices. Another factor depressing multifamily starts has been the rise in the rental vacancy rate to 6.3 percent, the highest level since 1967. In contrast to the jump in starts, permits for new construction were unchanged in June and remain depressed compared with a year ago.

Federal Government purchases of goods and services

rose by $2.4 billion in the second quarter, primarily as a result of an increase in nondefense expenditures. Defense spending was virtually unchanged, as it rose only $0.3 billion. State and local government outlays jointly climbed $4.8 billion, a somewhat smaller gain than in the previous quarter.

Largely reflecting the impact of the oil situation, the value of net exports during the second quarter dropped to $0.2 billion, $11.1 billion below the first-quarter level. The decline in net exports was in part a consequence of the post-embargo rise in the importation of higher priced oil. Also important was the decline in the receipts of American oil companies on their investments abroad as a result of the increased participation of the Saudi Arabian government in the Arabian American Oil Company. Such receipts are included as a plus element in the net export figures, and when they decline their effect is to reduce this component.

PRICE DEVELOPMENTS

Serious inflation persisted in the second quarter. The Commerce Department estimates that the implicit GNP price deflator climbed at an 8.8 percent annual rate in the April-June period, following an upward revised 12.3 percent rise in the first quarter of 1974. Over the four quarters ended in June, the deflator increased at a 9.5 percent annual rate, the highest rate of increase recorded in over twenty-five years. Since changes in the implicit deflator reflect shifts in the composition of spending as well as price changes, the Commerce Department also calculates a fixed-weight price index based on an unchanging composition of spending. In the second quarter, the fixed-weight GNP price index, which is based on the composition of 1967 spending, rose at an 11.2 percent annual rate, slightly less than the increase of 12.7 percent recorded in the first quarter.

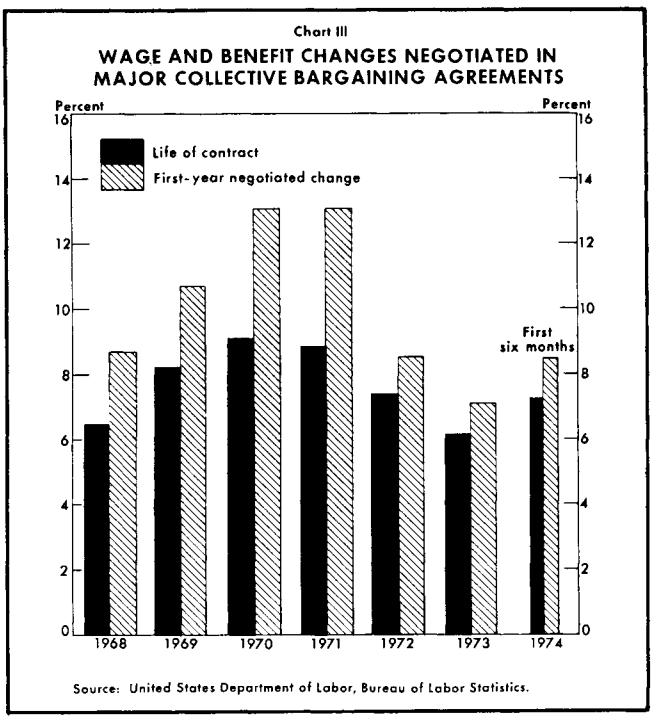
Consumer prices continued to increase at a very rapid rate in June, rising at an 11.5 percent seasonally adjusted annual rate. Over the twelve months ended in June, consumer prices spurted 11.1 percent, the largest increase in twenty-seven years. The broadly based June increase underscores the degree to which inflation has spread throughout the economy. While there was a marked slowdown in the increase in the prices of food and consumer power and fuel, large price increases were recorded for medical services, new and used automobiles, and household durables. Responding to some extent to the recent reductions of food prices at the wholesale level, retail food prices rose at a 3.8 percent annual rate in June, well below the 15.7 percent increase averaged over the previous twelve months. Prices of consumer power and fuel increased at a 14.9 percent annual rate in June, a substantially slower advance than the explosive 40.2 percent rise averaged over the previous six months. At least part of the bulge in prices of nonfood items in June is attributable to price increases instituted following the termination of the price controls program on May 1. Hence, current advances are to some extent only reflecting increases that were postponed by controls, and there is some hope that price gains may moderate in the future. On the other hand, cost pressures are not likely to ease in the near term in light of the recent upsurge in wage settlements.

Wholesale prices rose at a seasonally adjusted annual rate of 5.7 percent in June, well below the 14.4 percent annual rate advance averaged over the previous three months. This slowing was the result of the further fall in wholesale prices of farm products and processed foods. In posting their fourth consecutive decline, wholesale agricultural prices fell at an annual rate of 47.6 percent. It appears, however, that these declines may give way to increases in the near term. Forecasts of future crop harvests in the Midwest have been reduced, as unfavorable climatic conditions, first rain and then drought, have held down production. As a result, prices of agricultural commodities are rising once again. Continuing to reflect the end of the price controls and higher material costs, prices of wholesale industrial commodities rose at a 26.9 percent rate in June, compared with the 33.6 percent rate of increase averaged over the previous three months.

WAGES, PRODUCTIVITY, COLLECTIVE BARGAINING, AND EMPLOYMENT

Cost pressures continued strong in the second quarter as productivity remained relatively unchanged and as labor, in the face of continuing inflation and the end of wage controls, pressed for higher wage and benefit gains. Compensation per hour of work in the private sector rose at a 13.9 percent seasonally adjusted annual rate in the second quarter, the highest rate of increase in over twenty years and well above the 6.6 percent increase averaged over the previous four quarters. However, much of the second-quarter increase was attributable to a decline in hours worked in farming. In the nonfarm private sector, compensation rose at a 10.2 percent annual rate, compared with a rise of 8.5 percent in the first quarter. This advance resulted from an increase in hourly earnings and fringe benefits relative to hours of work.

As measured by real output per hour of work, second-quarter productivity in the private economy increased slightly at a 0.7 percent seasonally adjusted annual rate. This



increase was primarily the result of the precipitous decline in hours worked in the farm sector. It appears that the first-quarter farm hours worked were inflated as farmers rushed to bring additional land under cultivation but, with this accomplished, farm employment and hours have now fallen to levels comparable to a year ago. Excluding the variable farm sector, productivity in the private economy declined 2.8 percent. With productivity failing to record any significant rise and compensation rising sharply, unit labor costs during the second quarter rose at a 13.5 percent annual rate.

The recent declines in real wages have caused an upsurge in union demands and strike activity. The number of man-days lost because of strikes has jumped, with the second-quarter average the highest in over three years. During the past six months, first-year wage and benefit gains in collective bargaining settlements covering 5,000 or more workers aggregated 8.5 percent, a marked increase from last year's average first-year gain of 7.1 percent but well below the explosive advances recorded in early 1970 and 1971 (see Chart III). Over the life of the contract, wages and benefits rose 7.2 percent in the first half of 1974, rebounding from the six-year low of 6.1 percent recorded last year. Thus, although front loading—that is, providing a disproportionate share of the total increase in the first year of the contract—is on the upswing, the differential of first-year gains over life-of-contract advances has not approached the differential reached in 1970 and 1971 when labor last attempted to make up for lost purchasing power. Instead, it appears that a number of unions are focusing on protecting real wage gains by negotiating or liberalizing cost-of-living escalator clauses. In fact, over 10 percent of the collective bargaining settlements reached thus far in 1974 have adopted escalator provisions. Approximately 45 percent of all workers under major bargaining units are now covered by cost-of-living escalators. As a result of the growing importance of these escalators, the Bureau of Labor Statistics has initiated a new statistical series that includes the gains in cost-of-living escalators in contracts of 1,000 or more workers. These data indicate that first-year wages negotiated in the second quarter rose 10 percent, the highest quarterly advance in the six-quarter history of the new series. The escalator adjustments accounted for only 0.8 percentage point of this advance.

According to the monthly survey of households, conditions in the labor market changed little from June to July. As the growth in the civilian labor force outpaced the rise in employment, the unemployment rate edged up to 5.3 percent from the rate of 5.2 percent sustained over May and June. During July, the unemployment rate for most major labor force groups was unchanged, including the closely watched rate for married men that held at 2.6 percent. Among the labor force groups registering increases in jobless rates were white collar workers, adult women, nonwhites, and teen-agers. The 0.2 percentage point increase in the jobless rate for white collar workers increased their level of unemployment to 3.3 percent in July. The unemployment rate for adult women edged up 0.1 percentage point in July to 5.2 percent, and the volatile teen-age jobless rate rose from 15.6 percent to 16.2 percent. The nonwhite unemployment rate rose to 9.4 percent from 8.8 percent, compared with the 9.2 percent rate averaged over the first six months of 1974.

The July payroll survey of establishments diverged from the household survey, as seasonally adjusted nonfarm payroll employment declined 122,000, led by declines in employment in the construction and manufacturing industries. The two surveys often differ in a particular month because of sampling and coverage differences; however, over longer periods of time they tend to show comparable changes. While the number of production workers on factory payrolls declined, the average workweek in manufacturing rose 0.2 hours in July to 40.3 hours, despite a 0.1-hour drop in overtime. In the private nonfarm sector as a whole, the average workweek increased by 0.2 hours to 36.9 hours.

The Business Situation

The latest readings of business indicators suggest that the economy continues to drift at the sluggish pace that characterized the second quarter.* On balance, the modest gains recorded in some sectors have been offset by declines in others. Industrial production barely inched ahead in July and was still below the peak attained last November. Activity in the automotive sector picked up a bit in July, as sales and production of new domestic models registered advances. According to the advance report, the rise in auto sales led a substantial increase in July retail sales. Manufacturers continued to accumulate inventories at a rapid rate in July. Capital appropriations spurted in the second quarter, but smaller gains in business spending on plant and equipment are planned for the second half of the year than occurred over the first six months. The situation in the residential housing market deteriorated further in July, reflecting rising interest rates and the increasing scarcity of mortgage funds.

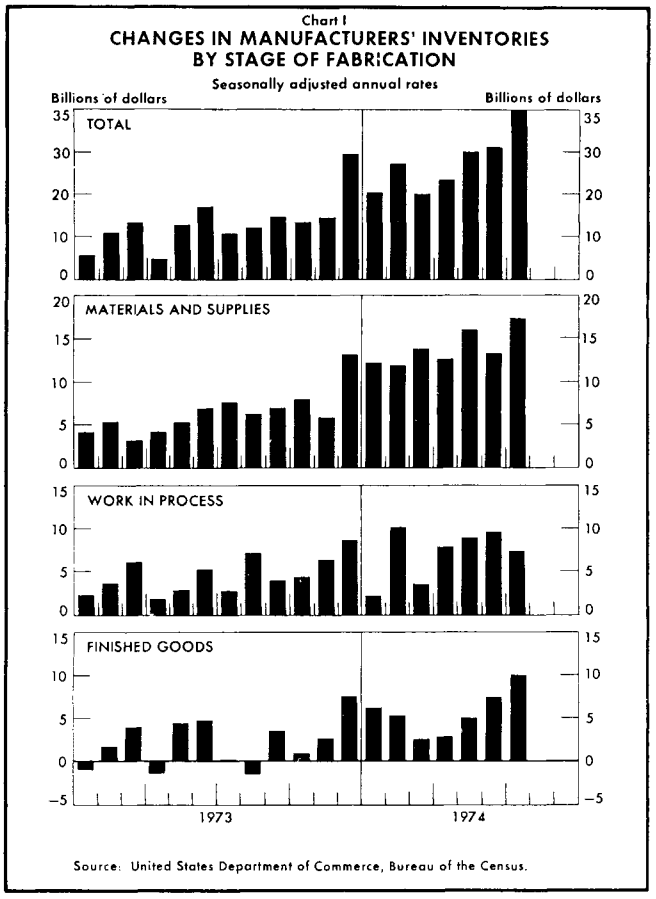
Despite the sluggishness of the economy, the price situation remains unrelentingly dismal. Prices of wholesale industrial and consumer nonfood commodities have continued to advance at excessively rapid rates. Evidently, these increases are largely the result of concurrent and past hikes in labor and materials costs, although to some extent the inflation may still reflect the end of price controls. In any event, the price outlook has been dealt yet another blow from the drought in the Midwest and sharp rises in the wholesale prices of grains and meats have already surfaced.

*The revised second-quarter estimates indicate that gross national product (GNP) rose $28.5 billion, or at a seasonally adjusted annual rate of 8.7 percent. The rate of increase in the implicit GNP deflator was revised upward slightly to 9.6 percent per annum, and the rate of decline in real GNP was revised to 0.8 percent. According to the preliminary estimates released along with the GNP revisions, pretax corporate profits were reported to have risen $11.7 billion to a seasonally adjusted annual rate of $150.4 billion.

INDUSTRIAL PRODUCTION, RETAIL SALES, ORDERS, AND INVENTORIES

The Federal Reserve Board's index of industrial production inched ahead at a seasonally adjusted annual rate of 1 percent in July, offsetting the decline of the previous month. Energy production continued to rebound in July and has climbed 10 percent at an annual rate since reaching its recent low in March. Production of consumer goods also rose modestly in July, while production of construction materials declined in response to the slowdown in residential building. Production of business equipment was unchanged, remaining close to the peak reached in May.

Following the sharp energy-shortage-related contraction in the opening months of the year, the recovery in industrial production has proceeded at a slow pace. Between March and July, output has grown at an average 2.4 percent annual rate. There is a possibility that in coming months energy shortages may again occur. For instance, in a recent announcement, the Federal Energy Administration projected some natural gas shortages this winter. Of course, the importance of natural gas shortages on economic activity will depend on a number of unknown factors, such as the severity of winter weather and the economy's ability to substitute alternative energy sources. The availability of at least one alternate energy source, coal, seems questionable inasmuch as the United Mine Workers contract expires in November. With coal inventories already low in the steel and utilities industries, a lengthy strike could bear heavily on economic activity. As a bargaining device, the mine workers already have employed "memorial" work stoppages that reduced coal production. In addition to these possible energy problems, the oil situation continues to be uncertain. Several member nations of the Organization of Petroleum Exporting Countries have recently announced production cutbacks in an attempt to support oil prices in the face of a growing world surplus of crude oil.



The automotive sector recorded further modest gains in July. Production of domestic passenger cars rose 1.3 percent in that month to an annual rate of 7.8 million units, the highest reading this year but still below any monthly figure for the 1971-73 interval. Continued strike activity at General Motors apparently served to hold output below the 8.5 million units scheduled for the month. In any event, new car assemblies in July were nearly 25 percent below those of a year earlier. Sales of new domestic-type cars increased in July to an annual rate of 8.2 million units, the most rapid sales pace since late last year. Continuing the trend which emerged after the termination of the Arab oil embargo, large cars accounted for an increased share of domestic auto sales in July.

According to the advance report, automotive sales accounted for more than two fifths of the substantial July rise in total retail sales, which is estimated at 4 percent (not an annual rate). Sales of other consumer durables rose moderately, while sales of nondurables posted a sizable 2.9 percent advance for the month.

New orders received by durable goods manufacturers rose in July by $1.01 billion, or 2.2 percent, about equal to the growth averaged over the first six months of this year. The July gain resulted totally from a large jump in orders in the transportation-equipment sector, due mainly to higher auto orders. However, these data are difficult to interpret precisely because the timing of the summer model changeover period complicates seasonal adjustment procedures. Excluding the transportation sector, new orders for durable goods in July fell 1.6 percent, led by a decline in bookings for primary metals. Although shipments of durable goods picked up sharply in July, the backlog of unfilled orders continued to climb, reaching a level 31.5 percent above the total of the corresponding month of last year.

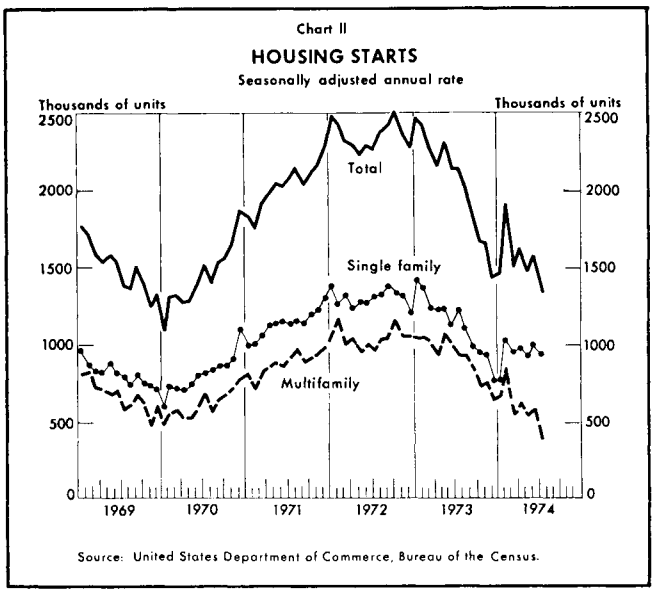
The book value of manufacturers' inventories increased sharply in July, rising at a seasonally adjusted annual rate of $35 billion (see Chart I). This was the largest increase in the current inventory buildup that began in December; over the December-July period, manufacturers have added an average $27 billion to their inventories. Despite the large increase in inventories in July, shipments rose at even a faster pace and the inventory-sales ratio in this sector declined to 1.62 months of shipments from 1.65. However, because of accounting practices, the change in book value of inventories, unlike shipments, only partially reflects the effect of spiraling prices. As a consequence, it is difficult to interpret whether the inventory buildup represents desired or unintended accumulation. Examining inventories by stage of fabrication suggests that finished goods are beginning to account for a larger portion of the increase in total inventories. While the bulk of July's increase continued to be in materials and supplies and work in process, finished goods inventories rose at a $10 billion annual rate in that month, substantially above the $5.6 billion rate of accumulation averaged since December.

CAPITAL SPENDING

According to the Commerce Department survey taken in July and August, business spending on new plant and equipment is now expected to rise 12.5 percent in 1974, slightly above the planned 12.2 percent increase indicated in the earlier survey. Over the first half of 1974, actual plant and equipment outlays are estimated to have risen $7.7 billion, or 14.8 percent at a seasonally adjusted annual rate, slightly above the gain expected in the earlier Commerce survey. However, as indicated in the earlier survey, smaller increases are planned for the second half of the year. A special survey taken by the Commerce Department in late 1973 indicated that spending on air-

and water-pollution-abatement equipment represented approximately one sixth of the planned increase in capital expenditures of all industries. At that time, planned anti-pollution expenditures represented more than 20 percent of the capital budgets of the nonferrous metals, iron and steel, and paper industries. Thus, taking into account pollution-abatement expenditures and the impact of inflation, the growth of the productive capacity of many industries will be considerably less than that indicated by total planned outlays in current dollars. Over the second half of 1974, nonmanufacturing outlays are expected to grow only modestly, with utilities and railroads paring earlier planned expenditures.

As reported by the Conference Board's survey of large manufacturers, capital appropriations jumped a sizzling 39 percent (not an annual rate) in the second quarter, with the increase concentrated in nondurable goods manufacturers, especially materials-producing industries. Leading the advance were increased appropriations in the petroleum, nonferrous metals, paper, and chemical industries. Since the change in appropriations reflects both changes in prices and planned real spending, the Conference Board has developed data that exclude the effect of inflation. In constant dollar terms, new appropriations rose a substantial 33 percent in the second quarter, and the backlog of unspent appropriations climbed 14 percent. Of course, appropriations may be canceled, and the timing of the planned expenditures is uncertain. Nevertheless, the size of the advance in new appropriations and backlogs in constant dollars suggests that increased business spending on new plant and equipment may be in the offing.



RESIDENTIAL CONSTRUCTION

Residential building activity slumped further in July under the pressures of high interest rates, escalating construction costs, and the scarcity of mortgage money. On a seasonally adjusted annual rate basis, housing starts fell to 1.3 million units in July, down almost 38 percent from a year earlier and the lowest level in over four years. While the entire residential construction sector has lately been depressed, multifamily units have been particularly hard hit (see Chart II). In July, multifamily starts amounted to 394,000 units at an annual rate, more than 57 percent below the level in the corresponding month of last year. In part, this decrease reflects a weakening in the demand for both rental and condominium apartments. In the second quarter, for example, the rental vacancy rate stood at a six-year high of 6.3 percent. Moreover, the availability of multiunit construction loans has been squeezed by the deteriorating financial position of real estate investment trusts, which supplied about 10 percent of all multifamily lending in 1973.

High market rates of interest have served to restrict the availability of mortgage money, as savers have channeled funds to instruments such as money market mutual funds, variable-rate notes of bank holding companies, and Treasury securities. Deposits at thrift institutions, seasonally adjusted, grew at only a 1.2 percent annual rate in July, the lowest rate since January 1970 and well below the 6.3 percent gain averaged in the first six months of the year. Over the three months ended in July, thrift deposits grew at a scant 3.2 percent annual rate. Mutual savings banks have been particularly hard hit, losing deposits on a seasonally adjusted basis in July for the third time in the past four months. In view of this slowdown in deposit flows, both savings and loan associations and mutual savings banks have become increasingly reluctant to make new mortgage commitments. In fact, outstanding mortgage commitments, seasonally adjusted, at savings and loan associations and New York State mutual savings banks have declined $2.6 billion, or 13 percent, since April.

By any measure, mortgage market interest rates have skyrocketed. In the Federal National Mortgage Association's (FNMA) August 26 auction, the yield on four-month FNMA commitments to purchase Government-insured mortgages rose to a record high of 10.38 percent, up 168 basis points from the January 1974 auction. In the primary mortgage market, rates also continued to soar.

In an attempt to remain competitive with conventional mortgages rates, the ceiling rate on Government-insured mortgages was raised 50 basis points in August to a record high of 9.50 percent. This marked the fourth time in five months that the ceiling on interest rates of mortgages insured by the Federal Housing Administration (FHA) and guaranteed by the Veterans Administration (VA) was raised. Moreover, prospective home buyers reportedly are facing even higher rates as the rates on mortgage commitments continue to rise.

Sales of single-family homes slowed to a seasonally adjusted annual rate of 539,000 units in June, down from the 598,000 units reached in May. The backlog of homes for sale remained virtually unchanged at 434,000 units. However, the median time that this inventory of homes has been on the market, as measured from ground breaking, rose to 8.3 months in June, from 7.6 months in May and the 6.2 months averaged in the first quarter. The seasonally adjusted ratio of homes available for sale to homes sold rose to 9.9 months of sales in June. Despite this weakening in sales, prices of new homes continued to advance. As measured by the Bureau of the Census index, the price of new one-family homes sold rose at a 13.2 percent annual rate in the second quarter, compared with a 7.6 percent increase in the first quarter and 10.5 percent in 1973. Shipments of mobile homes, which tended to hold up in previous housing downturns, declined in June to an annual rate of 441,000 units, well below the 600,000 units shipped a year ago.

Last May, the Federal Government announced an emergency housing program that was to provide up to $10.3 billion to the mortgage market. Thus far, it appears that this program has not had much impact, despite the strong reaction to the Federal Home Loan Mortgage Corporation's forward commitment program. Builders' response to the Government National Mortgage Association (GNMA) Tandem Plan has been quite slow, possibly because of the delays involved in obtaining FHA or VA approval. While activity appears to have picked up somewhat recently, GNMA still has unused authorization to purchase below-market-rate mortgages on about 175,000 units. Furthermore, it appears that savings and loan associations may be hesitating to add the subsidized Federal Home Loan Bank (FHLB) five-year advances provided by the emergency program to their already high borrowings from the FHLBs.

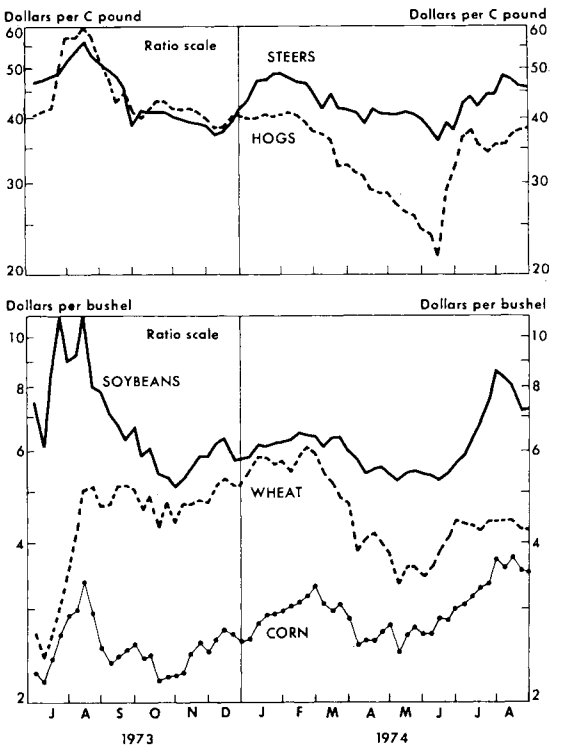
Regardless of the extent to which this program is utilized, it is not clear whether it will bring additional funds to the mortgage market or merely replace flows that otherwise would have occurred. A number of additional innovations are being proposed or instituted. New FHLB regulations allow member thrift institutions to issue large-denomination negotiable certificates of deposit; however, there is little evidence of aggressive bidding for funds by the thrift institutions. Most recently, the FHLB Board has proposed regulations that allow variable-rate mortgages, and legislation has just been passed in the Congress to raise the ceiling on Government-insured mortgages to $45,000. In addition, one large mutual savings bank, following the lead of several bank holding companies, has recently issued a variable-rate bond to raise funds.

PRICE DEVELOPMENTS

Inflation remains severe. According to the latest data, prices of wholesale industrial and consumer nonfood commodities have continued to advance at extremely rapid rates. As the termination date of price controls recedes further into the past, it becomes increasingly difficult to attribute price hikes to a post-controls bulge. Instead,

Chart III

SPOT PRICES FOR SELECTED AGRICULTURAL COMMODITIES



Source: The Wall Street Journal.

recent price increases appear to be the result of current and past rises in labor costs and in raw materials prices. Moreover, a resurgence in feed grain prices, which has already become visible at the spot and wholesale levels, suggests that there will be large increases in retail food prices in coming months.

Seasonally adjusted consumer prices climbed at a 9.1 percent annual rate in July, only the second time this year that the rate of increase was below 10 percent. However, almost all of the slowdown was the result of an outright decline in retail food prices, which may shortly be reversed. Apart from food prices, consumers continued to face stiff price hikes. Prices of consumer nonfood commodities, for instance, climbed at nearly a 16 percent annual rate in July, up slightly from the 15 percent rate of advance averaged in earlier months of the year. A sharp rise in the cost of medical care and household services resulted in a 12.7 percent increase in services prices.

In July, wholesale prices skyrocketed at a seasonally adjusted annual rate of 44.6 percent. With large increases being recorded in all sectors, the advance was the most rapid since August 1973. Industrial wholesale prices climbed at a 32.9 percent annual rate in July, or 6 percentage points higher than in the previous month. Higher materials costs contributed significantly to the increase, as prices for paper and metals registered substantial gains. In addition, previous slowdowns in the rate of growth in wholesale fuel and power prices were reversed. In July, energy prices rose at a 68.7 percent annual rate, bringing the increase over the last year to nearly 65 percent. Meanwhile, wholesale farm and feed prices rose at a 77.3 percent annual rate in July, thereby reversing four consecutive monthly declines. While most farm products prices moved higher, increases in prices of livestock and feed grains were particularly large. Early in July, cattlemen countered previous declines in beef prices by temporarily reducing marketings. At about the same time, prices for feed grains began to increase as forecasts of a record corn crop appeared less certain.

Over the four weeks ended August 27, the Bureau of Labor Statistics spot price index of basic commodities declined by 4.5 percent. Prices of raw industrial commodities fell, primarily as a result of a weakening in the price of scrap copper. Prices of raw foodstuffs posted declines over the last two weeks of August after advancing for eight of the previous nine weeks. Over this period, the increases in spot prices of feed grains were especially large. A severe drought which gripped the nation's Corn Belt caused the Agriculture Department to revise its estimates for the 1974 corn crop from 6.7 billion bushels to 5 billion, with smaller year-over-year declines in the projected 1974 crops of soybeans and other grains. In reaction, prices of corn and related feed grains soared. During July and the first part of August, for example, spot corn rose by 72 cents per bushel to $3.74 per bushel, although most recently corn prices have weakened somewhat (see Chart III). With near and distant future prices rising by large amounts, higher prices for several final products seem almost certain. Pork, poultry, eggs, and milk especially will be affected, as total feed costs including protein supplements rise. Despite the higher feed prices, however, beef prices may not climb significantly because of increased marketings of the large number of cattle on pasture.

The Business Situation

The latest business statistics indicate little change in the recent lackluster pace of economic activity. In September, domestic automobile sales declined, as the August spurt attributed to consumers' attempts to avoid the announced higher prices on 1975 models apparently ended. Also in September, the labor market weakened as the unemployment rate rose from 5.4 percent to 5.8 percent. In August, the dollar value of new orders at durable goods manufacturers rose sharply, and manufacturers' shipments and inventories continued to advance. Industrial production declined that month, however, and nonauto retail sales were unchanged. Construction continued depressed as housing starts and permits fell further.

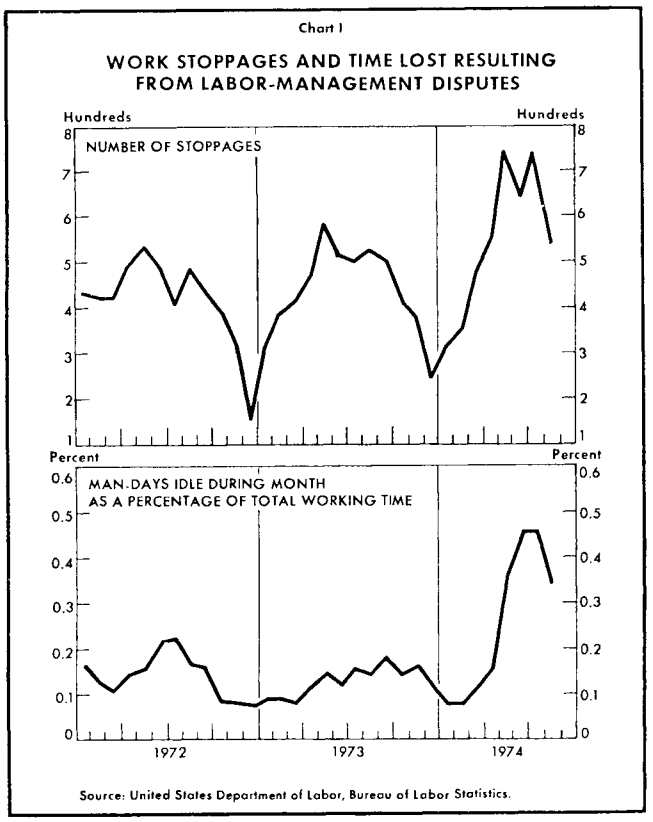
The most recent price statistics confirm a continuation of steep inflation. Moreover, a widespread feeling that a rollback in oil prices has become increasingly unlikely has been a source of additional concern. Wholesale prices exploded in August, and consumer prices posted their largest increase in a year. The pervasiveness of inflation was evident in price advances in all sectors of economic activity. The prices of services, foods, and nonfood commodities skyrocketed. Furthermore, concern over frost damage to the already weather-beaten Midwest corn and soybean crops has reversed the recent declines in spot prices of agricultural commodities.

INDUSTRIAL PRODUCTION AND WORK STOPPAGES

The Federal Reserve Board's index of industrial production fell at a seasonally adjusted annual rate of 4.8 percent in August. This was the sharpest decline in industrial output since last winter's energy-related contraction, leaving output 1 percent below the level of a year earlier. Although the size of the August decline was magnified by labor disputes in numerous industries, the pervasive sluggishness of economic activity suggested that production would have edged downward even in the absence of these disputes. Production of defense and space equipment, construction materials, and durable consumer goods all fell, in addition to the strike-related cutbacks in the production of business equipment, coal, and iron mining. The housing slump no doubt accounts for the decline in the output of construction materials. Also, since the reduction in consumer durable goods production was centered in household appliances and furniture, it too may reflect the depressed state of housing activity. As fewer new housing units are completed, correspondingly fewer new appliances are needed. In contrast to most major market groups, production of nondurable consumer goods and materials rose in August.

Despite the relative calm in most major collective bargaining negotiations, the number of work stoppages and working time lost from labor disputes have jumped since the end of wage controls in April. Thus, it appears that the attempts by unions to recoup lost purchasing power through wage increases and cost-of-living protection may be meeting stiff management resistance at smaller concerns. In the four months since wages were decontrolled in April, the number of stoppages have spurted sharply, averaging more than 660, compared with the 425 stoppages averaged in the first four months of 1974. In August, however, labor disputes moderated, declining to 540 from over 700 in July (see Chart I). The percentage of total working time lost by employees directly involved in these stoppages fell to 0.34 percent in August from the three-year high of 0.46 percent reached in June and July. This measure, which allows for the growth of the labor force, neglects the indirect or secondary effects on other establishments or industries where employees are idle as a result of material or service shortages. Despite this recent decline in strike activity, it is likely these strikes may have had greater direct impact on industrial production, as it appears that these disputes have shifted from construction to the manufacturing sector.

Nevertheless, the bulk of this year's heavy calendar of major collective bargaining agreements (defined by the Bureau of Labor Statistics as agreements covering 1,000 workers or more) that expire or contain wage reopening provisions have been peacefully settled. Major accords have been reached in the steel, telephone, aluminum, and can industries, with few or no labor-management disputes.



Even the volatile construction industry has had only relatively minor labor stoppages. However, one major industry settlement that could bear heavily on economic activity—coal—has not yet come up for renegotiation. Coal is an important energy source for the steel and electric utility industries. Indeed, it accounts for almost half of all the electricity produced in the United States. Coupled with the prospective shortages of natural gas this winter, a sustained nationwide strike by the United Mine Workers in November could have a seriously deleterious impact on the economy. Utilities' inventories of coal, which were already low in July, have been reduced further by August's "memorial" work stoppages. At least one major utility, the Tennessee Valley Authority, has already requested its users to reduce voluntarily electricity consumption in an attempt to maintain its dwindling stock of coal.

RETAIL SALES, NEW ORDERS, AND INVENTORIES

According to the advance report, retail sales in August rose at a 6.8 percent annual rate. However, the bulk of this increase was the result of the continued improvement in sales of new domestic automobiles, which in large part probably reflected the attempt by consumers to avoid the announced higher prices on the forthcoming 1975 models. Sales of nondurable goods rose in August but, excluding the automotive sector, durable goods sales slipped slightly. In September, sales of new cars weakened, although they remained ahead of the pace of early summer. New car inventories are down sharply from the peaks recorded in the gasoline-short winter months.

Allowing for the impact of surging prices, both durable and nondurable retail sales have shown little improvement in recent months, after recovering from last winter's lows. Slackening retail sales to some extent reflect the continued deterioration in real personal income that has characterized the twelve-month period ended in August. The most recent survey of consumer sentiment and spending plans suggests that little improvement is in the offing for real retail sales. The Conference Board's index of consumer confidence in August was close to a four-year low.

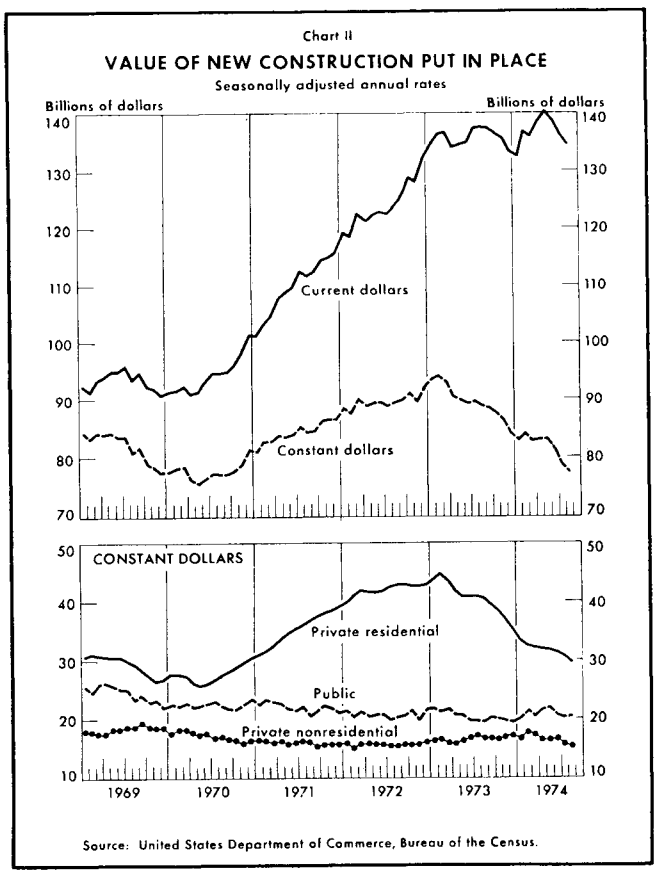
New orders received by durable goods manufacturers rose $1.73 billion, or 3.6 percent, in August. A sharp spurt in defense equipment orders, especially for aircraft, and a pickup in primary metals orders accounted for all of the advance. Excluding the defense sector, new orders registered a slight decline in August. Although new orders have risen almost continuously in 1974, these data are expressed in nominal terms and thus reflect the rapid rate of inflation. Allowing for the effect of higher wholesale prices of manufacturers' durable goods, it appears that the physical volume of new orders has advanced only slightly in the past few months.

As measured by their book value, manufacturers' inventories rose by $31 billion at an annual rate in August, the fourth consecutive month that the rate of inventory accumulation equaled or exceeded $30 billion. The August growth in manufacturers' shipments equaled that of inventories, leaving the inventory-sales ratio unchanged at 1.63 months of shipments. This apparent stability in the inventory-sales ratio, however, tends to disguise real accumulation since the value of sales reflects the rapid rate of inflation more fully than the book value of inventories. Despite this limitation, these inventory-sales ratios can indicate relative accumulation in particular sectors. Examination of these ratios by market groups indicates marked accumulation in the household durable and capital goods industries, where inventories have jumped over the past few months even though shipments have declined. Unlike recent months, in which finished goods accounted for a rising portion of the buildup in manufacturers' inventories, more than 80 percent of the August increase was in inventories of materials and supplies and work in process. At

the trade level, inventories at both wholesale and retail rose sharply in July, with nondurables inventories accounting for the bulk of the increase.

CONSTRUCTION

Residential construction activity deteriorated further in August, as mortgage market conditions became even more stringent. Housing starts dropped to an annual rate of 1.13 million units in August, down 44 percent from a year earlier and the lowest level in more than four years. While single-family starts were 26 percent below the level of a year ago, multifamily starts, which have been especially hard hit, stood at a seven-year low of 302,000 units in August. Building permits fell 10 percent in August to an annual rate of 912,000, the first time since early 1967 that newly issued permits have fallen below the million mark. Sales of single-family homes fell 15 percent at an annual rate in July to a level of 518,000 units. The inventory of unsold homes remained virtually unchanged and, at the current sales rate, represents a large ten months' supply.



The mortgage market tightened further in August. Despite a slight pickup in the growth of thrift deposits, which was concentrated at savings and loan associations, deposit growth remained near July's four-year low. In August, mutual savings banks, which have been hard hit by deposit outflows, suffered their fourth deposit loss in the past five months. As a result of these deposit flows, thrift institutions continued to curtail both their mortgage lending and their commitments to lend in the future. Interest rates on both new mortgage commitments and mortgage closings recently have climbed, with mortgage rates reportedly exceeding 10 percent in many areas of the nation in September.

After climbing to a peak in May, the value of new construction has begun to decline in recent months. Thus, it appears that the protracted decline in construction activity not only has spread beyond the residential building sector, but also has more than offset the effect of higher prices. Real construction outlays have been falling over the past eighteen months and dropped to a four-year low in August (see Chart II). In constant-dollar terms, private residential construction outlays have declined almost $17 billion from their peak in February 1973. Furthermore, spending on public construction, even though it has risen in current dollars over the past year and a half, has shown little real growth. Finally, private nonresidential construction activity, which edged upward in 1973 and early 1974, has recently been declining under the weight of high interest rates and construction costs.

PRICE DEVELOPMENTS

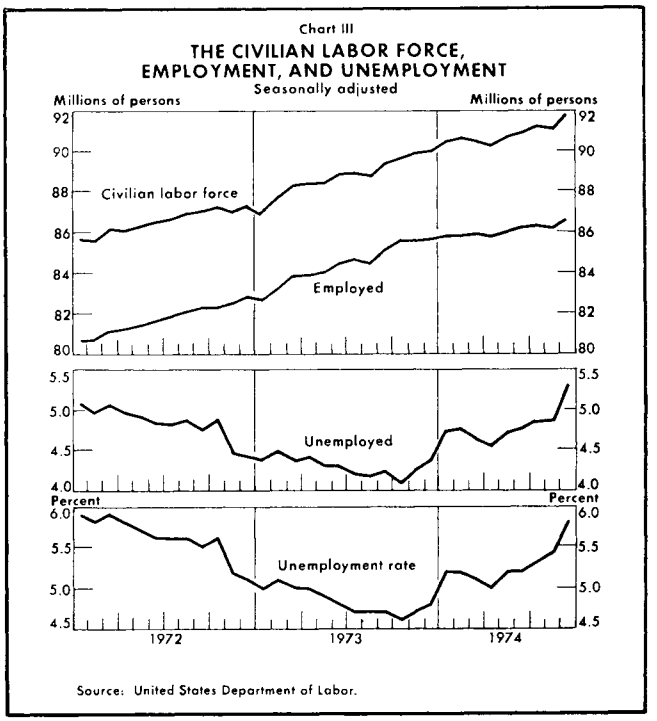
Inflationary pressures remain intense. According to the latest price statistics, almost all sectors of the economy continue to be gripped by accelerating inflation. In August, wholesale prices surged at a seasonally adjusted annual rate of more than 45 percent for the second consecutive month. As these wholesale price increases are likely to work their way through the economy, there can be little hope for near-term improvement in inflation at the retail level. The August advance in consumer food prices was the sharpest in six months, and the full impact of the drought-related runup in farm product prices has yet to be felt by the consumer. Moreover, the edging-down of agricultural spot prices following their earlier sharp advance has recently been reversed by concern over frost damage.

Consumer prices advanced at a 16 percent seasonally adjusted annual rate in August, the largest increase in one year. Also discouraging was the pervasiveness of the price

rise. The prices of both food and nonfood commodities rose at slightly more than a 17 percent annual rate, and prices of services increased at an annual rate of more than 13 percent. Gasoline prices were one of the few consumer prices that declined. Higher prices of meats, apparel, and medical care services led the consumer price advance.

Propelled by continuing increases in industrial prices and a large advance in the price of farm and food products, wholesale prices rose at a seasonally adjusted annual rate of 46.4 percent in August. Wholesale industrial prices rose 30.3 percent at an annual rate in the month and have advanced at a sizzling 32.9 percent annual rate thus far this year. Even after allowance for the expected price bulge due to the termination of controls, the magnitude and duration of the upsurge in wholesale industrial prices has sharply dimmed prospects of a near-term slowdown in the rate of inflation. Among the many products for which prices were higher in August, the increases in the prices of chemicals and paper and pulp products were especially large. In addition to the industrial price advance, prices of farm products and processed foods and feeds, led by increases in the prices of livestock and feed grains, skyrocketed for the second consecutive month, jumping at an 88.9 percent seasonally adjusted annual rate in August. However, agricultural prices have moved erratically, and earlier in the year wholesale farm and food prices declined for four consecutive months.

Concern over recent frost damage to Midwest crops has reversed earlier declines in spot prices of several agricultural commodities. Most notably, the prices of corn, soybeans, and other grains, which had begun to retreat from their drought-related peak in mid-August, have spurted in recent trading. For example, the spot price of corn, after falling more than 30 cents per bushel in the weeks following mid-August, has recently jumped above its earlier peak. Soybeans, which because of their longer growing period have been particularly hard hit by the frost, have jumped about $1.20 per bushel in the last two weeks of September.



LABOR MARKET DEVELOPMENTS

The sluggish pace of economic activity has resulted in weakness in the labor market (see Chart III). The seasonally adjusted unemployment rate rose 0.4 percentage point to 5.8 percent in September, the highest level in more than two years. Although the September jump in the jobless rate was widespread among most major age-sex groups, the burden fell more heavily on teen-agers, especially men, and women 25 years of age and over. The unemployment rate for male teen-agers jumped almost 2 percentage points to 17.1 percent in September, and the rate for women 25 years of age and over climbed a substantial 0.6 percentage point to 4.8 percent. The rate for married men rose to 2.8 percent, the highest for that group since October 1972. Most major industry groupings registered large increases in jobless rates; the 12.4 percent rate for construction workers was the highest in four years.

Despite the sluggishness of economic activity following the Arab oil embargo, the household survey indicates that civilian employment has risen by about 870,000 over the first nine months of this year. Employment increased by a substantial 351,000 workers in September. However, most of the September growth was the result of persons who, although seeking full-time employment, were forced to accept part-time employment. The number of these involuntary part-time workers jumped 310,000 in September, accounting for almost nine tenths of the growth of total employment. At the same time, the rise in the number of unemployed workers—948,000 over the first nine months of this year—has been primarily the result of growth in the labor force rather than increased layoffs. The civilian labor force rose sharply in September, continuing the growth that began in May. The bulk of the recent expansion in the labor force has stemmed from a pronounced

rise in the number of women and teen-agers seeking employment. Over the May-September period the number of adult women in the labor force has risen at a 4 percent annual rate and that of teen-agers surged at a 14.2 percent annual rate.

The separate payroll survey, which differs from the household survey in definition, coverage, and other factors, indicates that employment has grown by 520,000 workers over the first nine months of 1974, with most of the gain in the service-producing sector of the economy. In contrast to the similar employment growth recorded by these surveys over extended periods, payroll employment in September was considerably weaker than indicated by the household survey. Payroll employment remained relatively flat in that month, rising only 33,000 workers. This gain was particularly small in light of the large number of employees returning from strikes who did not appear on company payrolls in August.

Although in real terms workers' wages are probably continuing to decline, it does appear that unions have been successful to some extent in arresting the erosion in purchasing power that has resulted from inflation. The adjusted index of average hourly earnings for production workers on private nonagricultural payrolls increased at an 11.2 percent seasonally adjusted annual rate in September. Manufacturing earnings alone rose at a 12.9 percent rate in that month. Manufacturing wage gains adjusted for interindustry shifts and overtime have proceeded at a double-digit pace over the past six months, considerably above the pace of the earlier part of the year.

NEW PUBLICATION

The second booklet entitled *Glossary: Weekly Federal Reserve Statements* completes a pair of glossaries describing five weekly banking statistical reports published by the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York.

The 32-page, annotated booklet defines, line-by-line, the meaning of, and relationships among, the terms used in the weekly condition report of large commercial banks, the weekly summary of banking and credit measures, and the report covering the basic reserve position, Federal funds, and related transactions of eight major reserve city banks in New York City.

Both glossaries are available without charge from the Public Information Department, Federal Reserve Bank of New York, 33 Liberty Street, New York, N.Y. 10045.

The Business Situation

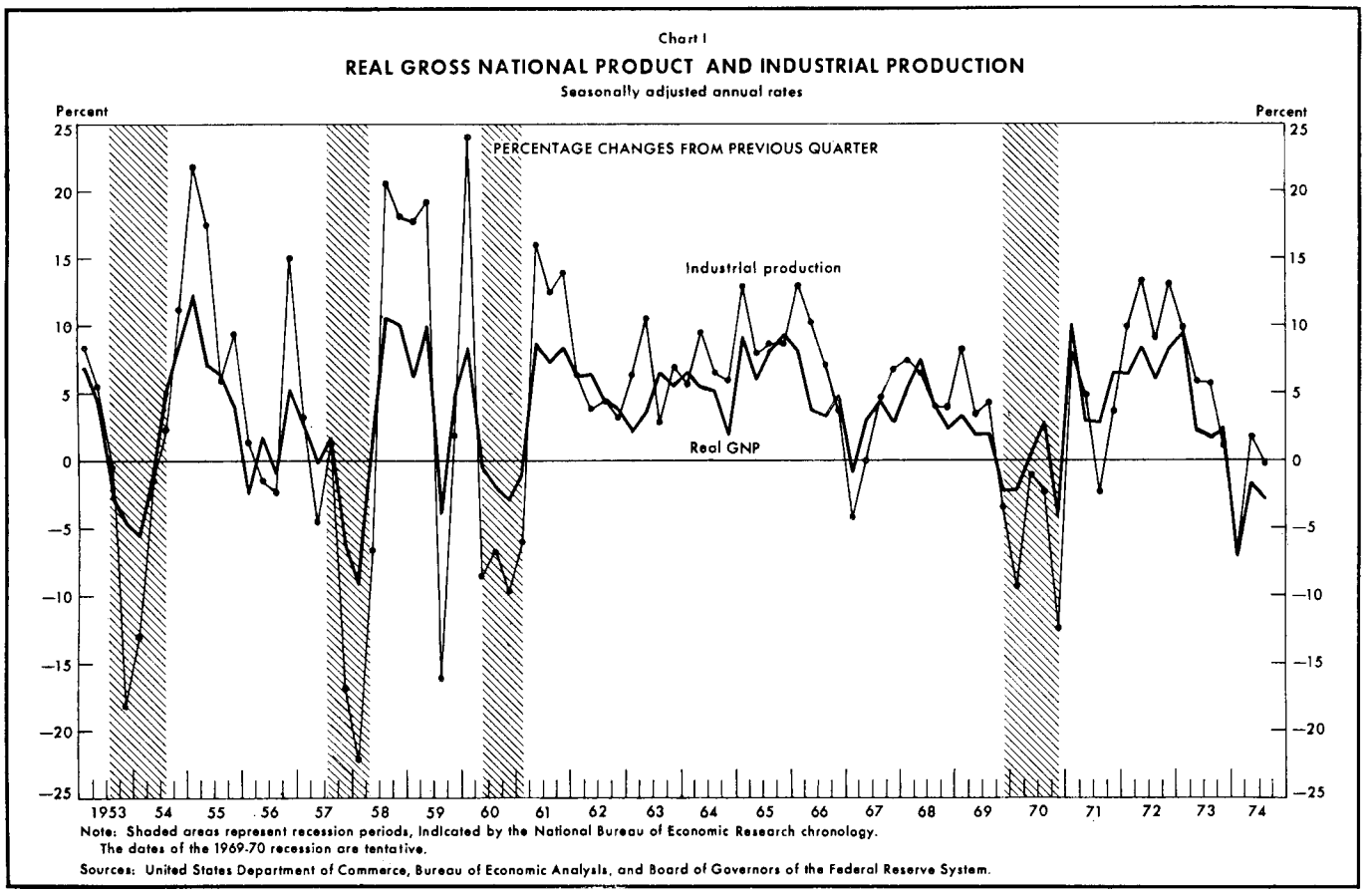
Economic activity dropped somewhat further in the third quarter. The gross national product (GNP) declined, after allowing for price changes, for the third consecutive quarter according to the preliminary estimate. Since its peak in the final three months of last year, real GNP has dropped about 3 percent, comparable to declines recorded during postwar recessionary periods. Other major indicators have shown somewhat less weakness this year, however. Thus, industrial production was about unchanged in the third quarter and is, so far, down only about 1.6 percent from its November 1973 peak. Employment actually rose a bit in the third quarter and in the year to date as a whole. While the third-quarter decline in overall real GNP apparently reflected mainly a rather sharp downward adjustment of inventories, there are few, if any, real signs of increased strength in the major demand sectors. Residential construction continues at depressed levels, and consumer confidence is apparently at a very low ebb. The continued sluggishness in the economy is being reflected, as had been widely expected, in rising unemployment, with the overall rate reaching 6 percent in October.

In the meanwhile, inflation remains exceptionally severe, although there are perhaps a few straws in the wind to suggest that some relief may be forthcoming. The GNP implicit price deflator, one of the broadest measures of prices, rose at an 11.5 percent annual rate in the third quarter. Except for the first three months of this year, this was the most rapid increase since the Korean war period. The fixed-weight deflator, which is unaffected by changes in the composition of output, rose at an even more rapid 12.8 percent annual rate over the July-September interval. However, as the quarter closed, there were signs of some easing of price pressures at the wholesale level. After registering the largest increase of the year in the previous month, wholesale prices in September rose only 1.1 percent at a seasonally adjusted annual rate. While the marked deceleration resulted mainly from a decline in farm and food product prices, the 12.4 percent annual rate of increase in wholesale prices of industrial commodities was the smallest since last October. Prices of a number of raw industrial commodities have continued their generally downward trend as a result of receding demand pressures in this country and abroad. However, such prices are only a small part of the costs of finished goods, which reflect accelerating wage costs as well. Hence, at the retail level prices have continued to surge, rising at a 15 percent annual rate in September.

GROSS NATIONAL PRODUCT AND RELATED DEVELOPMENTS

According to preliminary Department of Commerce estimates, the market value of the nation's output of goods and services rose by $27.8 billion in the third quarter of 1974, an 8.3 percent annual-rate increase. All of this rise, however, reflected higher prices, as real GNP declined at a 2.9 percent annual rate. Combined with the decrease of the two previous quarters, real GNP in the third quarter was down almost 3 percent from the peak attained at the end of last year. Thus far, the 1974 contraction in economic activity has deviated somewhat from the pattern of previous slowdowns, in which the decreases in real GNP were accompanied by even greater drops in industrial production (see Chart I). This time, the decrease in industrial production has been modest in comparison with that in real GNP and with its own behavior in previous cyclical declines. Industrial output in September was only 1.6 percent below its November 1973 peak, and this amounted to between one eighth and one fifth of the peak-to-trough contractions that occurred in 1969-70, 1960-61, 1957-58, and 1953-54.

Several factors have contributed to the recent atypical behavior of real GNP and industrial production. First, much of the decline in real GNP this year has reflected the very sharp contraction in residential housing activity. While home construction has typically fallen during cyclical declines, the recent drop has been unusually severe. This drop has had little effect on overall industrial production, with the exception of the decline in the output of construction materials and, perhaps, of the related dip



in the production of household appliances and furniture. Second, substantial buildups occurred in 1973 in the stocks of unfilled orders for durable manufactured goods and in unspent capital appropriations. No doubt these enlarged backlogs have cushioned production in recent months.

One of the major factors retarding the economy in the third quarter was the diminished rate of business inventory accumulation (see Chart II). Preliminary estimates based on partial data for the quarter indicate that investment in inventories amounted to only $5.8 billion in nominal terms in the July-September period, down from the $13.5 billion rate of accumulation of the previous quarter. In real terms, only durable manufacturing and farm stocks increased significantly in the third quarter. At the same time, the increase in current-dollar final expenditures—GNP excluding inventory investment—accelerated a bit to $35.5 billion, the biggest gain since the first quarter of last year.

Over the first nine months of this year, the pace of inventory investment has fallen off sharply from the unsustainable rate of accumulation recorded in the closing three months of 1973. In real terms, the decline in inventory spending in the first three quarters of the year has accounted for slightly more than two thirds of the total drop in aggregate demand. Businesses have continued to add to their stocks, however, and this has led to a steep runup in the ratio of real inventories to real final sales (see Chart III). In contrast, over this period, the ratio of book value inventories to total manufacturing and trade sales has remained fairly constant. To a large extent, the rapid rate of inflation has been the main factor behind the disparate behavior of these two indicators of inventory conditions, although there are other measurement and coverage differences. Much of the book value of inventories is valued in terms of past prices. Hence, in a period of rapid inflation, the book value of inventories will only incompletely reflect the higher market prices of inventoried

goods. This imparts a downward bias to the ratio of book-value inventories to manufacturing and trade sales during inflationary periods, since the latter are valued more nearly in terms of current market prices.

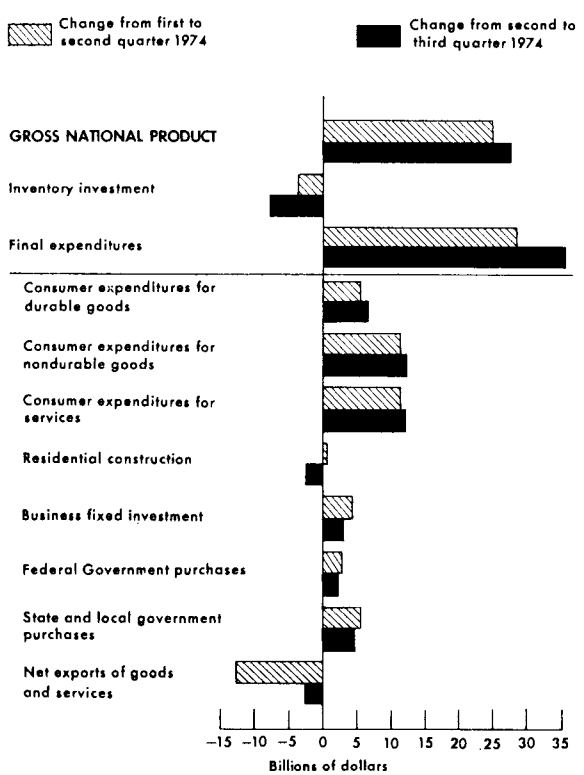
In view of the rising ratio of real GNP inventories to sales, the decreased rate of inventory spending may well represent a more or less orderly adjustment to rates of inventory accumulation consistent with present sluggish economic conditions. On the other hand, the recent switch by many businesses from first in-first out (FIFO) accounting to last in-first out (LIFO) may have artificially depressed the preliminary estimate of inventory accumulation in the third quarter. Other things being equal, an increase in the percentage of firms using LIFO implies a slower rate of gain in book value inventories. This effect should be offset by the inventory valuation adjustment (IVA) that is applied to the book value of inventories, measured partly in current prices and partly in terms of past prices, in order to obtain GNP business inventories, measured in current costs. However, the IVA is based on the mix of firms using LIFO and FIFO in the 1960's. An increase in the use of LIFO would lower the estimate of the IVA and thereby raise GNP inventory accumulation.

During the July-September period, personal consumption expenditures rose in both nominal and real terms. Following three consecutive quarterly declines, real outlays on consumer nondurable goods posted an increase in the most recent quarter. Likewise, consumers stepped up their spending on new automobiles. Domestic automobile sales climbed to an annual rate of 9.1 million units during the middle of the quarter, up from an average of 7.9 million units in the second quarter of the year. Much of this increase, however, appears to have resulted from the efforts of consumers to avoid the price hikes on the new 1975 models. Indeed, unit automobile sales fell sharply to 6.4 million units at an annual rate in October.

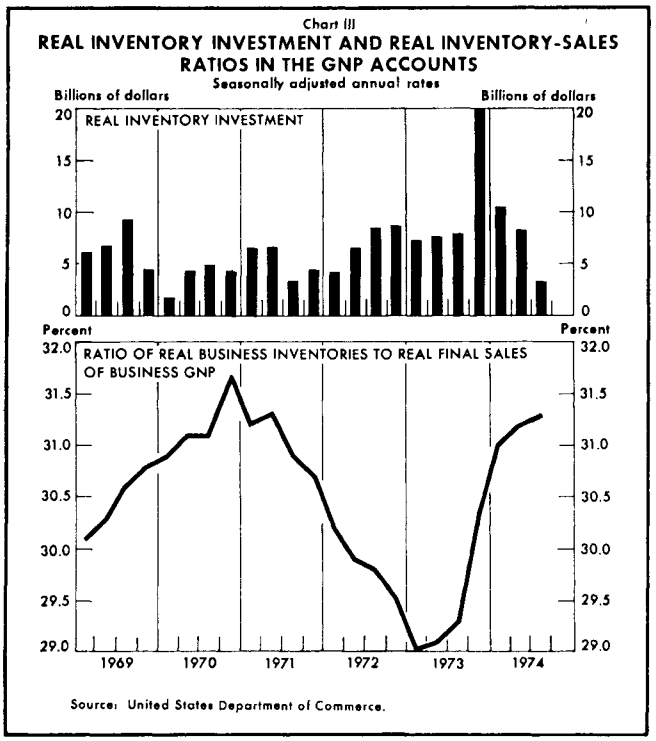
Personal consumption expenditures have contributed to the recent weakness in real GNP to a larger extent than in previous periods of economic downturn. In constant dollars, personal outlays on goods and services in the third quarter were $8.7 billion below the peak level of a year ago. The decline in real disposable income, as a result of the 12 percent hike in the prices of consumer goods and services and of the rise in unemployment, has been even more dramatic. The $21 billion drop in real spendable income over the last three quarters has been three to five times greater than declines experienced in the four post-Korean war recessions. Moreover, as consumer buying power continues to fall, an increasing proportion of consumer expenditures has been financed at the expense of personal savings; the personal saving rate declined to 6.5 percent in the third quarter, down from the 9.5 percent rate prevailing a year earlier.

Residential construction spending declined further in the third quarter. Following the modest $0.4 billion rise in the preceding period, outlays on residential structures dropped at a $2.5 billion seasonally adjusted annual rate in the July-September period. Because of the lag between the time when new housing units are started and the time of completion, the third-quarter decline in construction spending in part reflected the fall in starts in earlier months of the year. In addition, housing starts in the third quarter averaged about 25 percent below the rate of the first six months of the year and permits for new units dropped in September to the lowest level in nearly eight years. While the housing sector may be helped in the future by the decline in interest rates and by the Administration's new program wherein some $3 billion will be channeled

Chart II
RECENT CHANGES IN GROSS NATIONAL PRODUCT AND ITS COMPONENTS
Seasonally adjusted



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



to the mortgage market, the most recent statistics afford little encouragement about the near-term outlook.

In nominal terms, business spending on plant and equipment increased $3.1 billion during the July-September period, somewhat below the increase of the second quarter. A drop in expenditures on business structures was responsible for the slowing. Capacity utilization in manufacturing has fallen off in recent quarters, perhaps relieving pressure for immediate investment in buildings and equipment. In the third quarter, factories operated at 79.2 percent of capacity, down from 80.1 percent in the prior three months and the lowest level of utilization in two years. However, an early survey of planned plant and equipment spending in 1975 seems somewhat more encouraging. Outlays are expected to increase by 10 percent in that year, according to the survey prepared by Lionel D. Edie & Company Incorporated. This is close to the 12.5 percent increase expected this year. Of course, if the economy weakens significantly further, these plans may be pared back.

Government purchases of goods and services rose by $6.8 billion in the most recent quarter, compared with $8.1 billion in the previous three months. The $2.1 billion increase in Federal Government outlays centered in national defense spending. State and local government expenditures rose by $4.7 billion at a seasonally adjusted annual rate over the third quarter, down from the $5.3 billion increase in the second quarter of the year.

PRICE DEVELOPMENTS

Inflation remains a severe problem. The advance of the GNP implicit price deflator accelerated to an 11.5 percent annual rate in the third quarter. This was above the 9.4 percent rate of the second quarter and close to the first quarter's 12.3 percent annual-rate increase, the most rapid since the Korean war period. Farm prices declined slightly on balance over the period, but the implicit price deflator for the private nonfarm economy as a whole jumped 12.8 percent at an annual rate. The fixed-weight GNP price index, which is unaffected by changes in the composition of output, surged at a 12.8 percent rate in the July-September period.

At the wholesale level, price increases moderated a bit toward the end of the quarter. Following very rapid increases in July and August, seasonally adjusted wholesale prices registered a modest 1.1 percent annual-rate advance in September, the slowest climb in nearly a year. The index of wholesale agricultural prices declined 21 percent at an annual rate in that month, as the prices of animal feeds, grains, and livestock moved lower. However, since September, there have been signs of renewed pressure on wholesale food prices. Between mid-September and mid-October, prices received by the nation's farmers climbed at an annual rate of 47 percent, after falling by half that amount over the previous monthly period.

Some slowing was evident in the advance of wholesale industrial prices in September. Whereas these prices had risen at almost a 33 percent annual rate during the first eight months of the year, they increased at a 12.4 percent pace in September, with higher prices for machinery, chemicals, metals, and furniture and household durables accounting for most of the advance. By stage of fabrication, most of the September deceleration in industrial wholesale prices occurred at the crude and intermediate stages; the wholesale prices of consumer and producer finished goods continued to rise at fairly rapid rates.

Further easing in price increases at the wholesale level was evident in the latest survey conducted by the National Association of Purchasing Management, Inc. In October, 61 percent of the purchasing agents reported higher prices, down from 68 percent in September. Moreover, 12 percent of those reporting said they paid lower prices, up from 7 percent in September and only 2 percent in August. Hence, there are now fewer reports of higher prices than at any

time since July 1973, a period when prices were frozen, and the percentage of reports of lower prices is the largest in twelve years.

At the consumer level, prices continued to surge ahead in September, rising at a 15 percent annual rate to a level 12.1 percent above that of a year earlier. This constituted the largest yearly increase since 1947. Food prices led the September spurt, rising at a 22.3 percent annual rate, but the increases in prices of other consumer commodities and in services were not far behind. Prices of nonfood commodities rose at a seasonally adjusted annual rate of 12 percent during the month, primarily as a result of sizable increases in the prices of used cars and household durables. About one fourth of the 13.2 percent rise in prices of services was attributable to an increase in mortgage interest rates.

WAGES, PRODUCTIVITY, AND EMPLOYMENT

Cost pressures accelerated in the third quarter, as labor pressed for higher wage and benefit gains in the face of continuing inflation. Compensation per hour worked, which includes wages and fringe benefits, rose in the private economy at a seasonally adjusted annual rate of 10.6 percent, up from the average increase of 8.6 percent in the previous four quarters. However, the strong rise in compensation failed to offset recent consumer price increases. Measured in real terms, hourly compensation in the private sector declined by 2.4 percent at an annual rate.

According to a separate survey of collective bargaining agreements covering 5,000 or more workers, contracts settled in the third quarter provided for an 11.9 percent annual rise in wages and benefits over the first year of the contract and 7.9 percent annually over the contract life. In contrast, the second-quarter increases averaged 9 percent and 7.5 percent, respectively. For wages alone, first-year increases in contracts containing escalator clauses averaged 10.1 percent in the third quarter but actually yielded 10.4 percent before the end of the quarter because of the immediate effects of some escalator provisions. Since the beginning of the year, wage gains from escalator clauses have been substantial. New contracts with clauses signed during the first quarter of 1974 contained a fixed first-year wage boost of 6.4 percent. Through September, these contracts have yielded an average increase of 10.4 percent as a result of escalator payments.

Despite the larger initial wage increases, contracts settled during the third quarter provided for smaller average annual-wage increases over the life of the contract than those negotiated in the second quarter. The rise in escalator coverage, which included 49 percent of the workers involved in major settlements in the third quarter versus 44 percent in the April-June period, might account for the slight drop in wage increases over the life of the contract. Escalator pacts generally call for smaller fixed raises in expectation of larger increases through the escalator adjustment.

Output per hour worked in the private economy fell 2.8 percent at an annual rate in the third quarter. The decline in productivity, coupled with the sharp increase in hourly compensation, pushed unit labor costs ahead at a 13.9 percent annual rate during the third quarter, similar to the rise over the preceding three-month period.

The rise in the seasonally adjusted unemployment rate from 5.8 percent in September to 6 percent in October reflected the continued sluggish pace of the economy. In October, as in the previous month, about one half of the increase in unemployment resulted from job layoffs. The layoffs occurred primarily in the automotive industry and related sectors. Since mid-October, when the employment statistics were collected, automotive manufacturers have announced additional cutbacks in employment. Among age groups, the jump from 3.9 percent to 4.3 percent in the jobless rate of adult men accounted for most of the latest rise in the unemployment rate. The jobless rates for teen-agers and women were little changed from their September levels. Total employment was virtually unchanged in October, while the civilian labor force increased by 174,000 persons. Despite the slow pace of economic activity, employment has expanded by 842,000 workers since December 1973. Over the same period, the labor force increased by a substantial 2 million persons.

In the separate October survey of nonfarm establishments, the labor picture was much the same. Total payroll employment was basically unchanged over the month. However, manufacturing employment fell by 84,000 persons largely as a result of the automotive industry layoffs, and employment in the construction industry fell by 30,000 persons. In October, as in the previous nine months, the weakness in both construction and manufacturing employment was offset by increases in employment in the trade and services industries.

The Business Situation

Recent economic news indicates some further weakening in business activity.* In October, after months of comparative stability, industrial production posted a sharp, widely based decline, and the automobile industry made substantial layoffs in November and scheduled further cuts for December. New orders for durable manufactured goods fell somewhat further in October, and the backlog of unfilled durables orders dropped for the first time in over three years. Moreover, recent surveys of plant and equipment spending planned for 1975 suggest little or no increase, and quite possibly a decline, in real terms, from capital spending in 1974. Retail sales have continued to weaken, and home building remains depressed. Reflecting the slump in business activity, the unemployment rate jumped to 6.5 percent in November.

Despite the reduction of demand pressures, severe inflation persists. There are, however, some tentative signs that the slowdown in economic activity may be beginning to have an impact on prices at the wholesale and retail levels. While food prices have begun to climb again, the prices of commodities other than food have lately grown at significantly slower rates. Industrial wholesale prices increased at a 13.4 percent annual rate in October, about equal to the September rise but well below the almost 33 percent annual-rate increase averaged during the first eight months of the year. At the retail level, prices of nonfood commodities rose at a 6.8 percent annual rate in October, the smallest advance in a year.

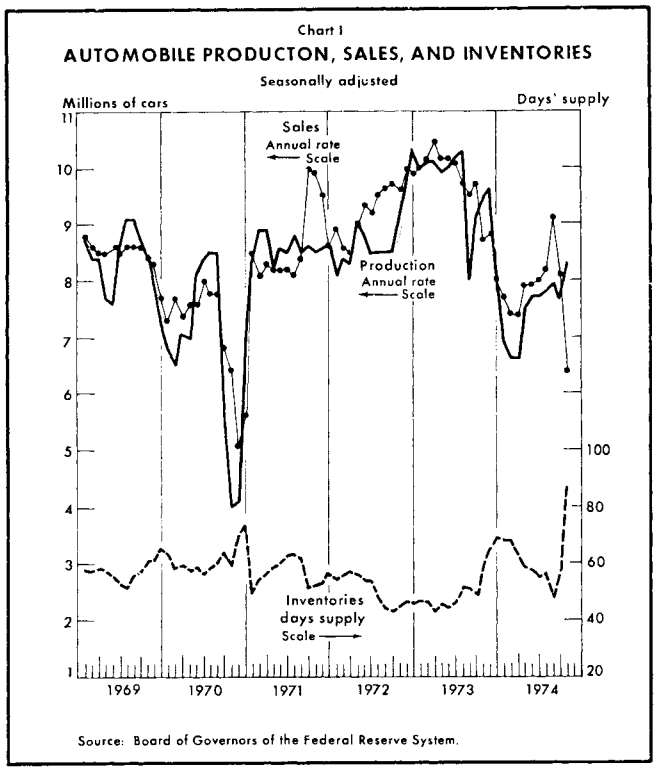
* The revised third-quarter estimates indicate that the gross national product (GNP) increased at a seasonally adjusted annual rate of 9.4 percent. The rate of growth of the implicit price deflator was revised upward to 11.8 percent per annum, and the rate of decline of real GNP was estimated to be 2.1 percent. According to the preliminary estimate released with the GNP revisions, pretax corporate profits were reported to have grown $1.1 billion to a seasonally adjusted annual rate of $106.7 billion.

INDUSTRIAL PRODUCTION

Industrial production declined at a 6.7 percent annual rate in October. In the previous eight months, the output of the nation's factories, utilities, and mines had been fairly stable, having even recovered somewhat from the sharp drop induced by the oil embargo last winter. However, the October decline put the level of production below the third-quarter average and 2 percent below the November 1973 peak. Decreases in output in October occurred in nonautomotive consumer durables, construction materials, and a wide range of other durable and nondurable materials. At the same time, however, business equipment output edged up and steel production remained high, possibly in anticipation of the coal workers' strike.

The strike by members of the United Mine Workers union, which began on November 12, undoubtedly had an adverse impact on industrial production in November. Within a week of the strike's onset, steel mill output had begun to slow down. Subsequently, layoffs were announced by the major steel companies, and total steel production fell 12.5 percent in the four weeks ended December 7. The effect of the four-week strike on other coal-dependent industries was probably minimized by stockpiling and the already slow rates of production.

In the automotive industry, scheduled production cuts for November and December reflect the dramatic fall in new car sales and the existence of large stocks of unsold cars. Auto manufacturers misjudged demand for new 1975 models in October, producing at an annual rate of 8.3 million units while sales dropped off to an annual rate of 6.4 million units (see Chart I). As a result, inventories of auto dealers jumped from an average fifty-eight days' supply in September to eighty-seven days' supply in October. In response, all four United States automotive manufacturers drastically reduced production plans for November and December.



CAPITAL SPENDING, DURABLES ORDERS, AND INVENTORIES

Appropriations for new plant and equipment by the nation's 1,000 largest manufacturers advanced by 8.5 percent in the third quarter, according to preliminary estimates by The Conference Board, Inc. However, excluding the capacity-short petroleum industry, the third-quarter rise was only 4.6 percent, and the Conference Board estimates that inflation accounted for almost all of this increase. For the economy as a whole, the McGraw-Hill survey of anticipated outlays on plant and equipment projects a 12 percent rise in 1975, about the same as this year. However, if realized, the survey also reports that these plans amount to little, if any, change in real terms. Moreover, planned expenditures on plant and equipment in 1974 have already been pared, according to the latest survey conducted by the Department of Commerce. The projected increase in outlays in the fourth quarter is now placed at 0.4 percent, significantly lower than the August survey estimate of 2.8 percent.

Preliminary data indicate that new orders for durable manufactured goods fell in October by $1.1 billion, after dropping by $3.1 billion in September. Most of the decline over the last two months occurred in the capital goods industry, but bookings in all sectors, including primary metals and transportation equipment, are significantly below their August levels. Unfilled orders of durables, which have probably cushioned the drop in production in recent months, fell in October for the first time in almost three and one-half years; the 1 percent decline was widespread. The latest survey conducted by the National Association of Purchasing Management, Inc., indicates a continued weakening in new orders in November. Declining orders were noted by 48 percent of those reporting in November, up from 39 percent in October and the largest percentage in twenty-six years.

In September, manufacturing and trade inventories rose by a sizable $4.5 billion, little changed from the advances recorded in the last four months. Coupled with a slight fall in business sales, this resulted in a sharp jump in the ratio of the book value of manufacturing and trade inventories to sales. Although the level of the current inventory-sales ratio does not appear to be very high by historical standards, two factors suggest that stocks may be somewhat more excessive than indicated by this ratio. First, the ratio of book-value inventories to manufacturing and trade sales is an underestimate of the true inventory-sales ratio during inflationary periods, because much of the book value of inventories is valued in terms of past prices while sales are valued more nearly in terms of current market prices. Second, the composition of recent inventory gains tends to suggest some unintended inventory accumulation: the accumulation of finished goods inventories accounted for 41 percent of the total change in manufacturers' inventories in September, contrasting sharply with the 27 percent average over the previous three months. In October, the portion of finished goods to total manufacturers' inventory accumulation remained at 41 percent.

PERSONAL INCOME, RETAIL SALES, AND RESIDENTIAL CONSTRUCTION

Personal income rose by $8.4 billion in October, about the same rate of total increase as over the past year. However, in the private sector, wage and salary gains slowed substantially, moving up by only $2.8 billion at an annual rate in contrast to a $5.7 billion advance in September. Manufacturing payrolls alone rose by $1.7 billion, as increases in average hourly earnings offset declines in employment and the average workweek. At the same time that income growth in the private sector began to lag, the

implementation of a pay raise for Federal Government employees added $2.1 billion to the increase in personal income.

Consumer spending continued at a sluggish pace. According to the advance report, retail sales fell by 0.4 percent in October, following a larger 2.1 percent drop in September. In real terms, sales have been weakening for some time. Indeed, as of October 1974, constant-dollar retail sales were 6 percent below what they had been a year earlier. Declines in real disposable income and general economic uncertainties have made the consumer wary. The index of consumer sentiment prepared by the University of Michigan fell to 64.5 percent in the third quarter. This was about the same level as in the first quarter of 1974, when fears associated with the oil embargo pushed the index to the lowest point in the twenty-eight-year history of the Michigan survey.

The slump in auto sales more than accounted for the October decline in retail sales. According to the Michigan survey, auto buying has been hurt by widespread awareness of record price increases. Moreover, the cost of financing purchases of autos has continued to rise: the finance rate charged consumers by major automotive finance companies, as published by the Board of Governors of the Federal Reserve System, averaged 14.03 percent in September, up from 13.82 percent in August and 13.45 percent in September 1973.

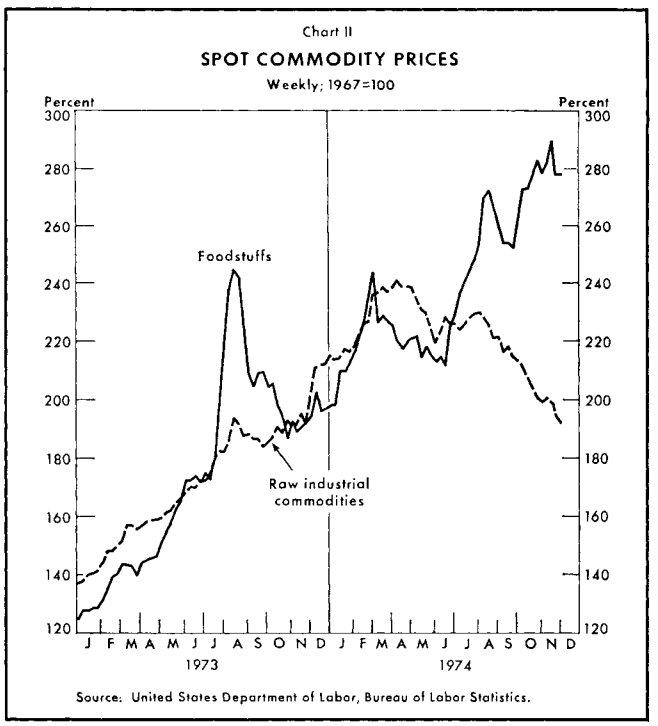
Residential construction remains at depressed levels. In October, housing starts edged down to a seasonally adjusted annual rate of 1.1 million units, little changed since August but 32.9 percent below a year ago. Total permits for new housing units fell 2.6 percent during October to a seasonally adjusted annual rate of 802,000 units, the seventh straight monthly decline. Rapid increases in the prices of homes, low levels of consumer confidence, high mortgage rates, and lack of mortgage money have all contributed to the weakness in the housing sector. Deposit growth at thrift institutions has picked up recently, with inflows to savings and loan associations and mutual savings banks rising by 5.3 percent in October or twice as much as the average for the previous three months. Thrift institutions may concentrate on rebuilding their liquidity over the near term, but continued deposit inflows should eventually lead to improvement in the availability of mortgage funds.

PRICES

Wholesale prices surged ahead in October, bringing the rise over the last twelve months to 22.6 percent, the largest yearly increase since 1947. After edging up at an annual rate of only 1.1 percent in September, the seasonally adjusted index of wholesale prices jumped by 27.9 percent at an annual rate, as food prices resumed their climb. The index for farm products, processed foods, and feeds has moved irregularly upward over the past year to a level 10.6 percent above October 1973, and the trend is expected to continue. However, recent spot prices indicate a slight easing in farm prices in November (see Chart II). The spot price index rose only 0.3 percent from mid-October to mid-November, after rising 10 percent over the previous monthly period.

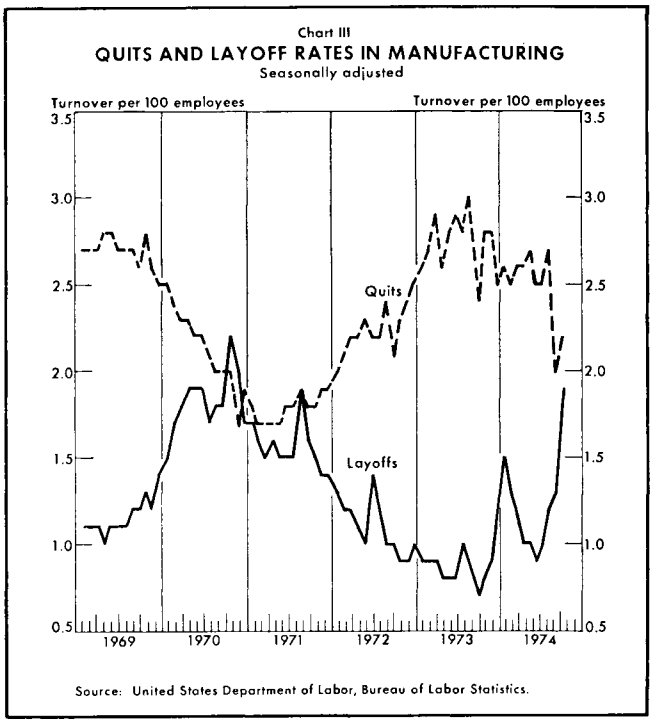
Industrial commodity prices rose at a 13.4 percent annual rate in October. While high by historical standards, the 13 percent advance in the index over the last two months is considerably less than the 32.9 percent average annual increase in the first eight months of 1974. Moreover, about one third of the October rise is attributable to higher 1975-model car prices. (About two thirds of the average $386 increase in the price per car was included in the wholesale price index, because one third of it was attributed to improvements such as pollution control devices. To the extent that increases in prices of products are traceable to improved quality, that increase is not reflected in the index.)

The slowdown in industrial commodities price increases



reflects, in part, the recent slackening in basic raw materials prices. Over the last three months, the index of crude materials excluding food and feed has risen only 0.2 percent at an annual rate. This compares with an increase in the previous seven months of 1974 of 47.1 percent at an annual rate. However, while raw materials have stabilized in price, the cost of finished goods continues to surge at rates somewhat more than 20 percent on an annual basis. These prices probably reflect previous increases in raw materials prices as well as accelerating wage costs.

Total consumer prices climbed at an annual rate of 10.3 percent in October, down from 15 percent in September and 16 percent in August. While food prices have continued to surge—the food component of the consumer price index rose 16 percent at an annual rate in October as higher prices for sugar, cereal, and bakery products offset declines in meat and poultry prices—the rate of increase in the prices of nonfood commodities has slowed significantly in the last two months. In October, the index of all commodities less food rose 6.8 percent at an annual rate, down substantially from 12 percent in September and an 18.2 percent annual-rate increase in August. Attempts to liquidate finished goods inventories in the face of softening demand may be contributing to the slowing in the rate of price increases. The latest price rise reflected increases in new and used car prices.



LABOR MARKET DEVELOPMENTS

The nation's civilian unemployment rate soared to 6.5 percent in November, the highest level since October 1961. The 0.5 percentage point rise, which was widespread among major age and sex groupings, reflected the continued economic slump. Total civilian employment fell by 785,000 workers in November to the lowest level since December 1973. Over the first ten months of this year, employment had been advancing at a slow but irregular pace.

In the November payroll survey of nonfarm establishments, seasonally adjusted employment fell by 443,000 workers. Since this survey was taken early in the month, the drop did not reflect the strike by 120,000 members of the United Mine Workers union. The recent decline was pervasive, with employment down substantially in, among other sectors, machinery, electrical equipment, transportation equipment, furniture, and primary metals. Movements in the labor turnover rates underscore the deteriorating situation in the manufacturing sector (see Chart III). The layoff rate has jumped sharply from a rate of 1.3 per 100 employees in September to 1.9 percent in October, and the November and December figures, when available, will probably show that further increases occurred during those months because of shutdowns in the auto industry. Meanwhile, indicative of the reduced job opportunities, the number of people voluntarily leaving their present jobs has declined from an average rate of 2.6 workers per 100 employees in the first eight months of the year to 2.1 percent in September and October combined.

The employment picture was further clouded by the sharp drop in the average workweek. Production workers' average weekly hours dropped by 0.4 hour to 36.2 hours in November, the lowest level in the fourteen-year history of the survey. In manufacturing, the average workweek fell 0.6 hour in November to 39.5 hours. Overtime also dropped sharply, from 3.2 hours in the previous month to 2.7 hours in November.