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THE BUSINESS SITUATION

The auto strike cut significantly into the Nation's output of goods and services in the fourth quarter. The Commerce Department's Office of Business Economics states in the "Business Situation" article in the January issue of the Survey of Current Business that real output would very probably have risen in the absence of the strike. In that case, the fourth quarter would have seen a continuation of the moderate expansion which began last summer. As it was, real GNP fell at an annual rate of 3-1/4 percent while GNP in current prices rose only 2-1/4 percent or \$5-1/2 billion.

The strike also affected the behavior of the implicit GNP price deflator, which rose in the fourth quarter at an annual rate of 5-3/4 percent, compared to 4-1/2 percent in the third. The deflator is a measure in which component price indexes are combined with weights that reflect the composition of each quarter's GNP. The strike cut most deeply into the inventory investment and the consumer and producer auto purchase components of GNP, all of which have relatively low deflators, and it was the reduction in the weights of these components which accounted for much of the acceleration in the rise of the deflator.

The "Business Situation" article also contains a brief assessment of the economic outlook for 1971.

More

OUTLOOK FOR 1971

It is generally expected that some recovery of lost auto production and a buildup of steel inventories will buoy production during the first half of 1971. Beyond that the task of assessing the outlook is greatly complicated because the distortions caused by past and prospective strikes will be obscuring underlying trends through most of the year. The economy should be stronger this year than last, but the speed of recovery is subject to various crucial uncertainties.

The strong recovery in homebuilding brought starts to a surprisingly high annual rate of 1.75 million units in the fourth quarter. A reasonable expectation for 1971 seems to be a starts total roughly equal to that rate. Residential investment expenditures, which lag behind starts, could be up as much as 25 percent for the year as a whole, compared to the 1970 total. Of course, the key to sustaining the homebuilding recovery is continuation of the greatly improved mortgage credit conditions which developed last year.

In contrast, business fixed investment is expected to provide little if any stimulus this year. The recent OBE-SEC survey found businessmen planning to increase outlays for plant and equipment by only 1-1/2 percent. It is possible that a rising trend of economic activity will result in some expansion of investment programs, but any such revisions are likely to be moderate.

Inventory investment is likely to be moderately stronger this year, but it is improbable that there will be a sharp acceleration such as has characterized many past cyclical recoveries. The inventory correction in the 1969-70 slowdown was relatively mild, and thus did not set the stage for a surge in accumulation as demands strengthen.

The growth of State and local government purchases should accelerate somewhat. The steady advance of payrolls will continue and it seems probable that many construction projects postponed because of financing problems will be rescheduled. Federal purchases in 1971 are unlikely to differ much from the 1970 total. Defense purchases are expected to continue to decline, with the contraction concentrated in the first half of the year, but this decline will be largely offset by increasing nondefense purchases; in the second half of the year total Federal purchases are expected to turn up.

Consumer demand looms as a big unknown. Consumers entered 1971 in a financial position that presents the potential for strong spending, but attitudes remain cautious and confidence is likely to be slow to strengthen so long as unemployment remains high and consumers remain uncertain over economic conditions. It seems likely that the saving rate will decline somewhat this year, but a big drop awaits the strengthening of consumer confidence. To a large extent this development depends on the success of economic policy.

As the year began, policy was clearly stimulative and had as its objective the reduction of both unemployment and inflation. However, the amount of progress that can be made on these two objectives depends on a crucial unknown, the extent to which policy can be expansionary without generating inflationary tendencies.

It is very difficult to judge the degree of progress that will be made toward reducing unemployment. With respect to prices, the strong productivity gains that typically accompany economic recovery should help in the short run to moderate unit labor costs, and thus to relieve a key upward pressure on prices. However, slowing the rate of price increase in conditions of economic expansion and high rates of resource utilization depends importantly upon the attitudes of labor and business. Under present circumstances, a reduction of inflationary expectations should permit progress toward slowing the rise of hourly compensation. Failing this, unit labor costs will be rising rapidly again when productivity growth slows to a more normal pace. Moreover, the achievement of relative price stability requires that a slowdown in costs be permitted to affect product prices, consistent with a restoration of profits to levels more adequate than those that have prevailed recently.

The Survey of Current Business is available from Field Offices of the Department of Commerce, or from the Superintendent of Documents, U.S. Government Printing Office, Washington, D. C. 20402, at an annual subscription price of \$9, including weekly supplement; single copy, \$1.