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.

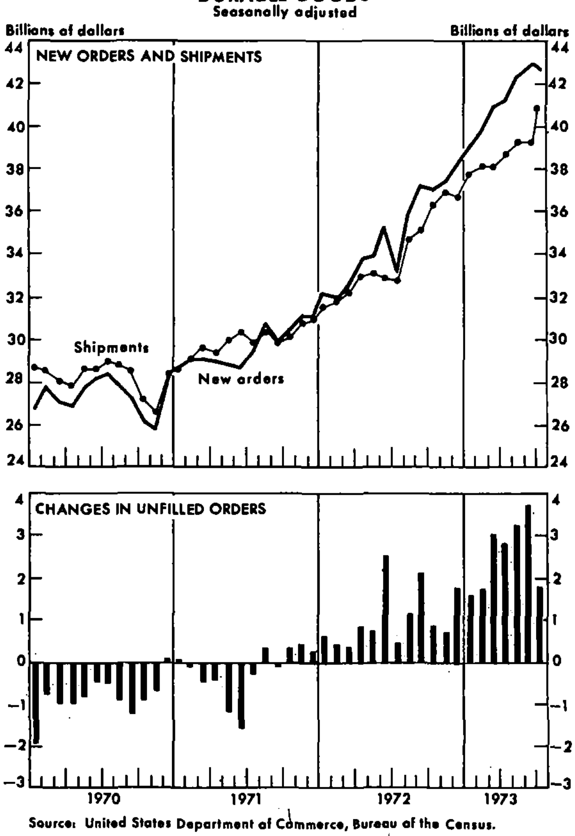
justed annual rate, indicate that sufficient demand for such high production levels is being maintained. The current strong demand for autos may be, however, partly a result of consumer attempts to escape higher prices expected for 1974 models because of additional mandatory antipollution and safety 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.

Chart I

ORDERS AND SHIPMENTS OF MANUFACTURED DURABLE GOODS

Seasonally adjusted



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

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.

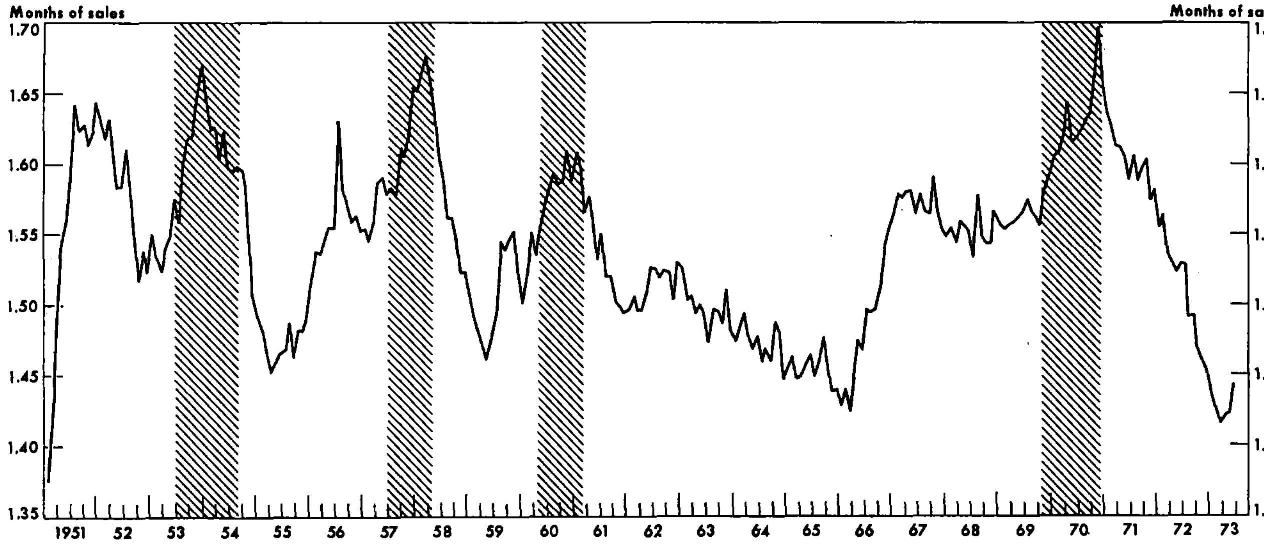
According to a Conference Board survey, net new capital appropriations of the 1,000 largest manufacturing firms rose by 11.6 percent (seasonally adjusted) during the second quarter, following a 17.2 percent first-quarter rise. Excluding the rather volatile petroleum and coal category, net new appropriations 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

Chart II

BUSINESS INVENTORY-SALES RATIO

Seasonally adjusted



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

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.

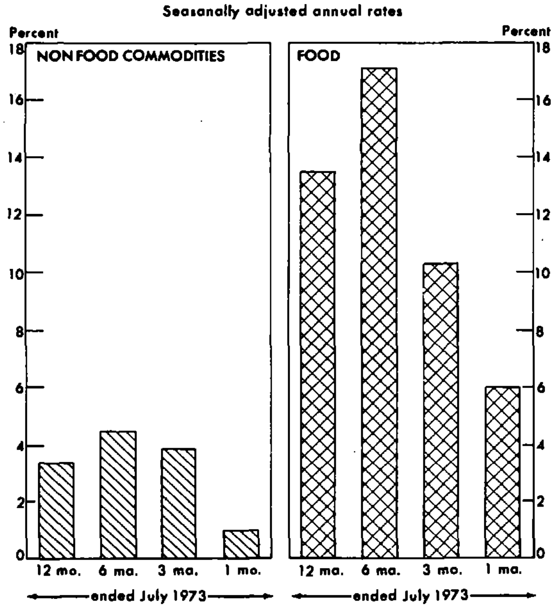
Recent evidence suggests that residential construction activity has moderated from the hectic pace of 1972 and early 1973. Housing starts rose in July to a seasonally adjusted annual rate of 2.18 million units. However, taking a somewhat longer perspective, the July pace was slightly slower than the 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.

Chart III

CHANGES IN CONSUMER PRICES

Seasonally adjusted annual rates



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

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.