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.

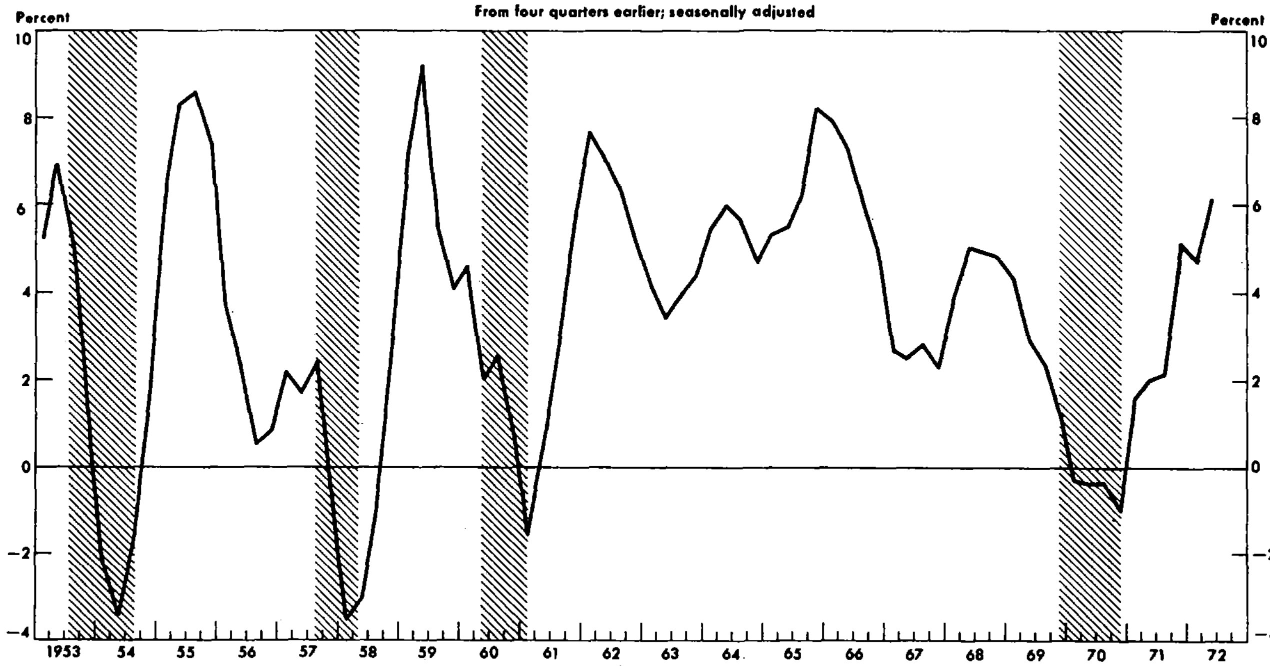
Personal consumption expenditures rose by $16.4 billion over the April-June period to a seasonally adjusted annual rate of $712.5 billion. Outlays for nondurable goods and services posted relatively strong gains, while the increase in spending for durables moderated somewhat from the pace of the previous 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

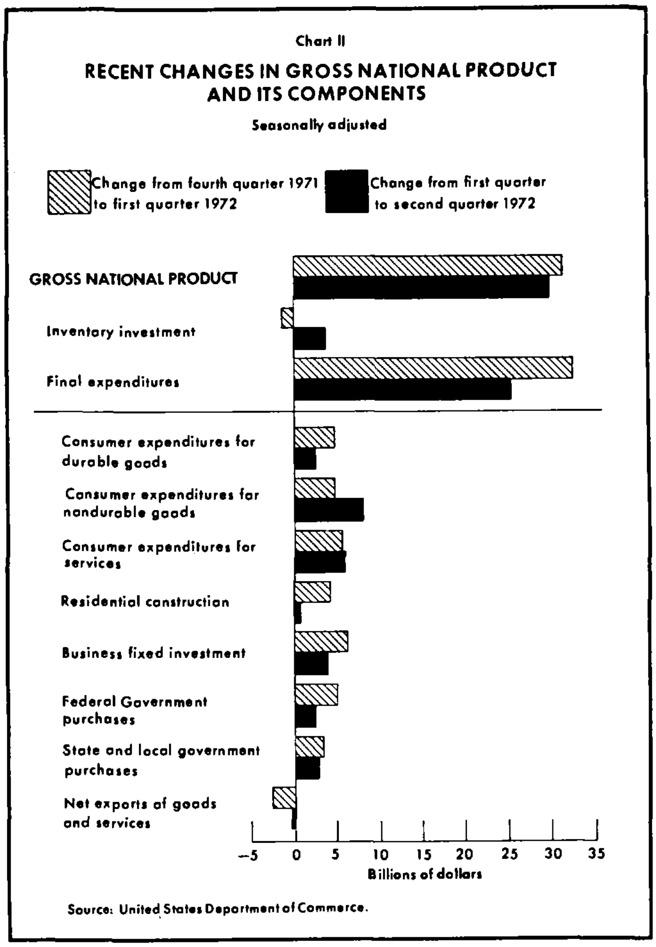
From four quarters earlier; seasonally adjusted



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 deflator 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.

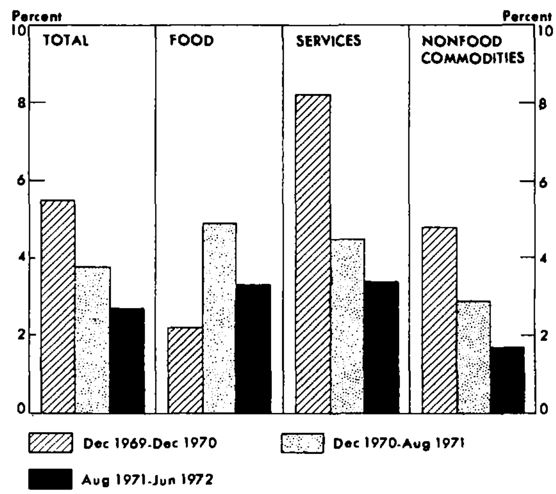
At the wholesale level, prices rose in July at a seasonally adjusted annual rate of 8.6 percent, the sharpest gain since August of last year. This huge July bulge mainly reflected a large increase in prices of farm products and processed foods and feeds which surged ahead at over a 24 percent annual 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.