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

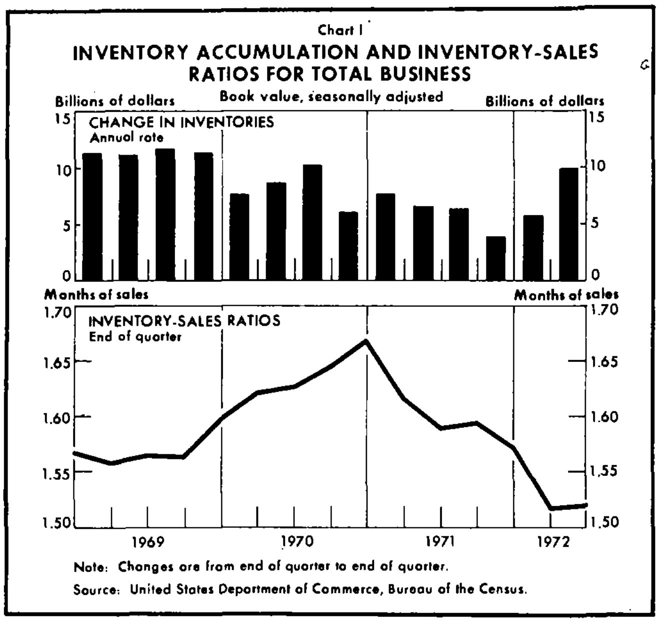


Chart I
INVENTORY ACCUMULATION AND INVENTORY-SALES RATIOS FOR TOTAL BUSINESS

Note: Changes are from end of quarter to end of quarter.
Source: United States Department of Commerce, Bureau of the Census.

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

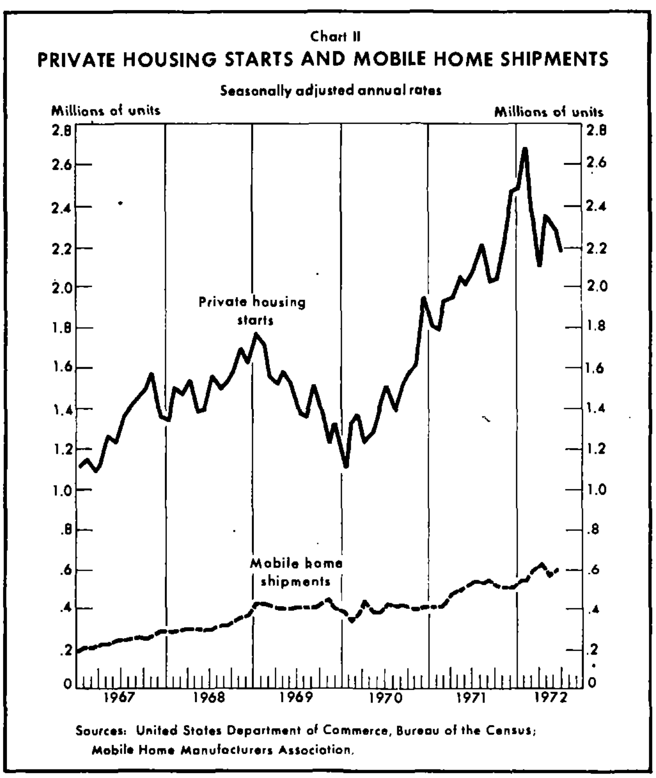
Personal income rose by a substantial $11.3 billion in July, after dropping by $1.1 billion in the preceding month. Both the July spurt and the June decline largely reflected the effects of Hurricane Agnes. Huge capital losses—representing damage to residential structures and proprietors' plant and equipment 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.



Sources: United States Department of Commerce, Bureau of the Census; Mobile Home Manufacturers Association.

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.

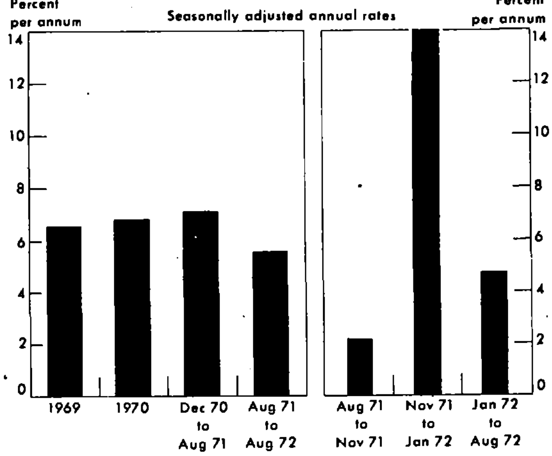
EMPLOYMENT, WAGES, AND PRICES

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

Chart III

CHANGES IN AVERAGE HOURLY EARNINGS
PRIVATE NONFARM ECONOMY

Seasonally adjusted annual rates



Note: Changes are adjusted for overtime (manufacturing only) and for interindustry employment shifts.

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

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.