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.

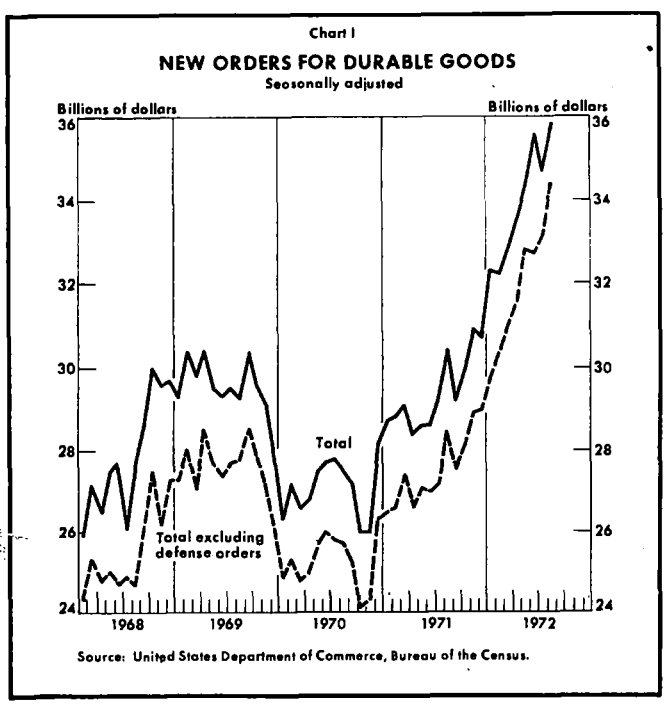
INDUSTRIAL PRODUCTION, ORDERS, AND INVENTORIES

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.

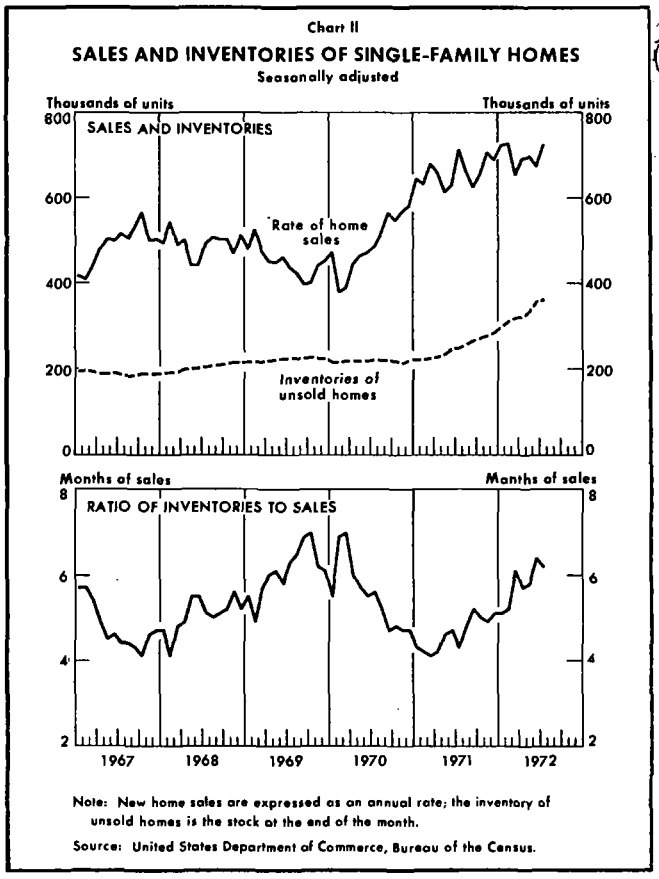
PERSONAL INCOME AND RETAIL SALES

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.



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.

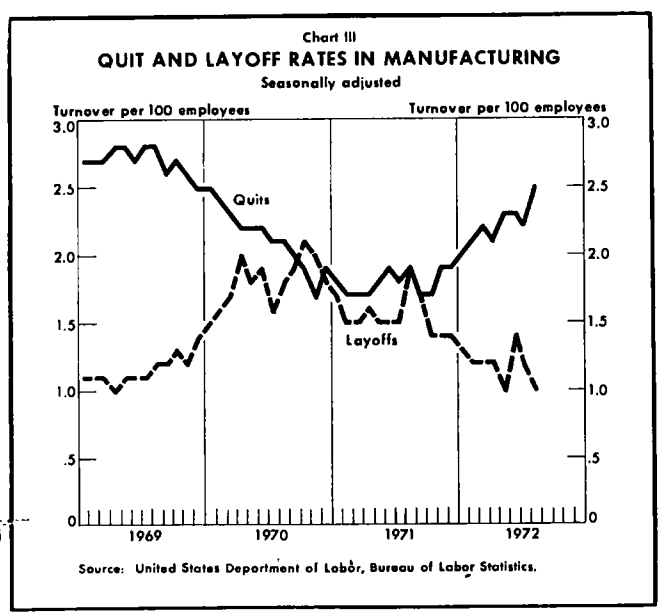
EMPLOYMENT AND PRICES

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.