

The Business Situation

Recent business statistics indicate that the economy is continuing to move ahead briskly. Real gross national product (GNP) increased at an annual rate of 5.9 percent in the third quarter. While this gain was smaller than the exceptionally large advance in the preceding quarter, the reduction in the rate of growth was confined mainly to inventory investment and defense spending and does not seem to indicate any weakening in the underlying economic situation. Consumers, businesses, and state and local governments all vigorously expanded their demands for goods and services. Surveys of consumer sentiment, moreover, suggest a marked improvement in confidence in recent months. New orders for durable goods, capital appropriations, and plans for investment in plant and equipment further point the way to continued robust economic activity. Indeed, a large gain in employment occurred in October, although a similarly large increase in the labor force held the unemployment rate unchanged at 5.5 percent.

On the price front, the course of inflation has apparently changed little recently, as prices continue to rise at comparatively moderate rates. The fixed-weight price deflator for total GNP increased at a 2.9 percent annual rate in the third quarter. The consumer price index, however, rose at a somewhat faster rate in the third quarter than in the first half of the year, reflecting in part the large September increase. Much of this acceleration was a result of the run-up in food prices. On the other hand, there was a noticeable easing in the rate of rise in wholesale industrial prices in the third quarter. The situation improved even further in October, when industrial prices actually fell slightly.

GROSS NATIONAL PRODUCT AND RELATED DEVELOPMENTS

Preliminary estimates prepared by the Department of Commerce indicate that the total market value of the nation's output of goods and services rose \$22.8 billion in the third quarter, an 8.3 percent seasonally adjusted annual rate of gain. Only about one fourth of this advance, moreover, was the result of higher prices. Valued in terms

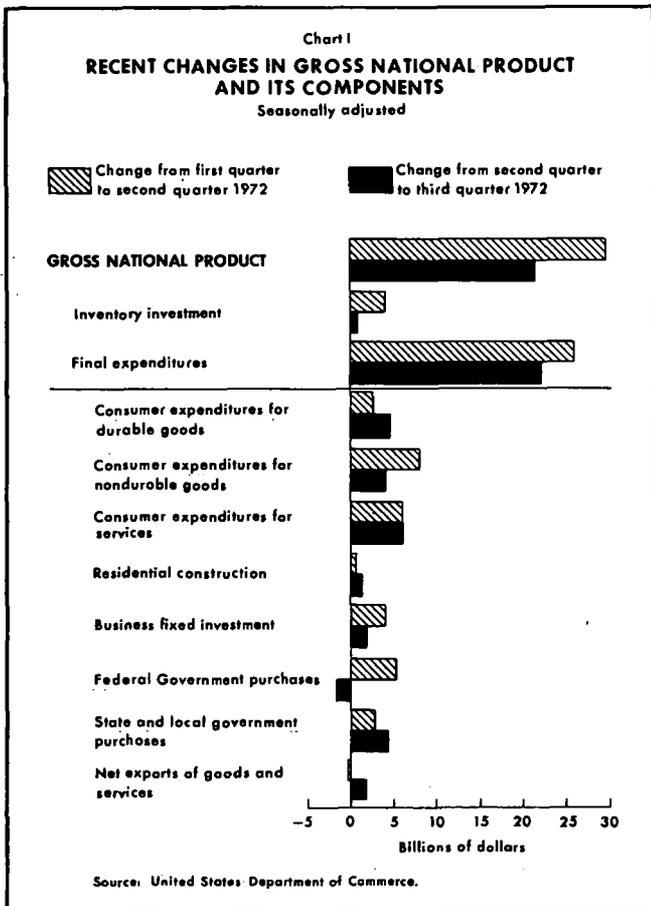
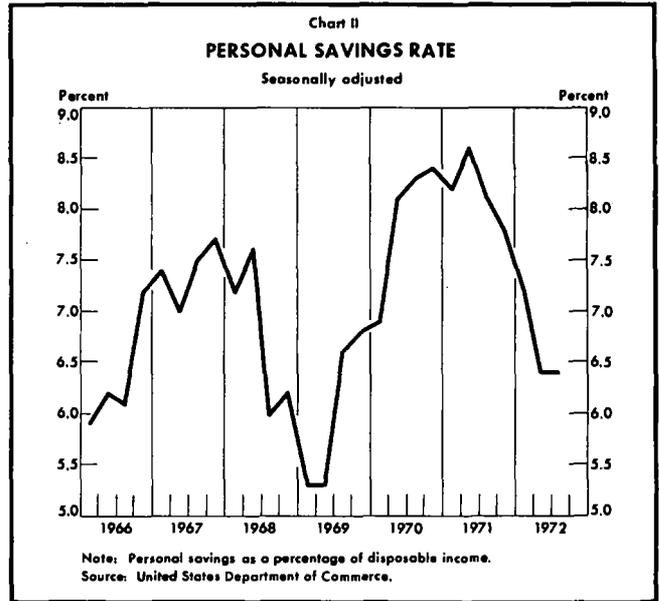
of 1958 prices, output of goods and services (real GNP) expanded at a 5.9 percent annual rate during the third quarter. This was still a sizable advance, even though it was overshadowed by the exceptionally large 9.4 percent rate of rise in real GNP in the preceding quarter. Over the last four quarters, the real growth has been an impressive 7.1 percent, slightly more than twice the average increase between 1953 and 1971.

The reduction in the rate of GNP growth in the third quarter was centered mainly in inventory investment and in defense spending by the Federal Government, both of which had shown quite large increases in the preceding quarter. Indeed, final expenditures on nondefense goods and services actually rose slightly faster in the July-September period than they had in the previous three months. This increase in final spending, moreover, was widely distributed throughout the economy (see Chart I).

Inventory investment is tentatively reported to have contributed a very modest \$0.7 billion to the increase in GNP in the third quarter, down markedly from the \$4.6 billion rise in the previous three months. This comparison, however, obscures the turnabout in inventory spending that has occurred in recent months. Nonagricultural businesses added \$5.3 billion worth of goods to their inventory stocks in the third quarter, following an only slightly smaller addition during the previous three months. The accumulations in these two quarters together exceeded those of the preceding four combined. To a considerable degree, this quickening in the pace of inventory spending has reflected developments within the manufacturing sector. After running down their inventories throughout 1971, manufacturers began to enlarge their stocks at the start of the current year, with the increment in each quarter exceeding that of the previous one. At the same time, wholesale and retail establishments have also been stepping up the pace of their inventory spending, albeit somewhat cautiously. Nevertheless, the increases in the book value of total business inventories have remained proportionately smaller than those in total business sales, and the inventory-sales ratio has continued

to trend downward. In August, the latest month for which data are available, this ratio declined to 1.48 months of sales, the lowest level since mid-1966.

Consumption spending again climbed vigorously in the third quarter. Personal consumption expenditures rose by a sizable \$14.7 billion over that period, a seasonally adjusted annual rate of increase of 8.5 percent. Although this was off somewhat from the advance during the first half of the year, it still constituted a healthy gain. Looking at the first nine months of the year as a whole, the rises in expenditures on consumer durables, nondurables, and services were all considerably larger than they had been in the preceding three quarters. Indeed, the rapid expansion in consumption spending this year has been a major underpinning of the faster pace of the recovery in economic activity. Moreover, results of the latest consumer surveys, which attempt to plumb consumers' attitudes directly, point to a marked improvement in confidence and buying plans in recent months.



The third-quarter moderation in the growth of personal consumption expenditures was accompanied by a leveling-off in the personal savings rate. After falling precipitously from its peak of 8.6 percent of disposable income in the second quarter of 1971 to 6.4 percent in the corresponding quarter this year, the savings rate was unchanged at this level in the July-September period (see Chart II). Inasmuch as disposable income tends to be rather closely linked to GNP, the decline in the savings rate underscores the important role that the growth of consumption has played in the overall expansion in economic activity during the year. It should be noted, however, that the overwithholding of personal income taxes may be artificially depressing the savings rate to some extent. Some estimates have placed the amount of overwithheld taxes at around \$8 billion, and some individuals may be treating these funds as a form of saving.

Expenditures on residential construction edged up \$1.4 billion in the third quarter. Though this increase was a bit larger than that of the previous quarter, it remained well below the gains of the preceding year and a half. This apparent leveling-off in the growth of spending on residential structures, which had been widely anticipated, reflected a peaking-out in the rate at which new homes were begun in earlier months of the year. Since work progresses on a new housing unit for some time after construction is begun, expenditures tend to continue upward even after housing starts have turned downward. During the opening

three months of the year, housing starts soared to a new record, averaging 2.5 million units at a seasonally adjusted annual rate. While starts in each of the succeeding six months were below the first-quarter average, they remained quite strong by historical standards. In the third quarter, for example, the average number of housing units started was only 7 percent below that of the January-March period.

Business expenditures on fixed investment goods rose by \$1.9 billion in the third quarter, well below the \$4.3 billion increase averaged in the preceding nine months. Over the first three quarters of the year, these outlays have grown at a 14 percent seasonally adjusted annual rate, up from the 11.5 percent rise recorded in 1971. These expenditures data, moreover, understate somewhat the strengthening in the demand for fixed investment goods, as they usually do during an extended upswing. This arises because of the lags separating decisions to begin new investment projects, the initiation of work on these projects, and final completion of the projects. Quarterly data on capital appropriations and expenditures of the nation's 1,000 largest manufacturers collected by The Conference Board are available through the second quarter of this year. During the first half of the year, these companies expanded their net new appropriations at close to a 40 percent annual rate, adding substantially to the backlog of unspent appropriations. Similarly, Commerce Department data indicate that the growth in new orders for nondefense capital equipment has outpaced that of shipments of these goods over the first nine months of the year, and consequently the backlog of unfilled orders for these goods has risen. Recent survey data suggest that this substantial demand for fixed investment goods will extend into next year as well. The latest Lionel D. Edie & Company Inc. survey of intended plant and equipment spending in 1973 calls for a 10 percent increase above the 1972 level, while the McGraw-Hill survey indicates an 11 percent increase in expenditures planned for 1973.

Government purchases of goods and services contributed only \$2.5 billion to the rise in current-dollar GNP in the third quarter, the smallest gain in over a year. At the Federal level, a large decrease in defense spending swamped spending increases for other goods and services and fully accounted for the slowdown in total government expenditures. State and local governments, on the other hand, raised their expenditures by a sizable \$4.4 billion in the third quarter. The recent passage of revenue sharing may further bolster spending by state and local governments in coming quarters, though some Federal funds may be used to replace other financing by the local authorities and would not lead to additional spending.

PRICE DEVELOPMENTS

The various price indicators continue to show mixed—though, on balance, encouraging—results. In general, it appears that prices have been rising in recent months at much slower rates than during the period preceding the inauguration of the Economic Stabilization Program in August 1971. At the same time, however, there is no clear-cut evidence that inflation has lately slowed further from the rates that had prevailed earlier this year.

According to preliminary estimates, the implicit price deflator for total GNP advanced at a 2.2 percent seasonally adjusted annual rate in the third quarter. This rise was a bit higher than that registered in the preceding three-month interval, but it was still a considerable improvement over the experience of the past several years. However, the recent performance of the implicit price deflator understates to some extent the ongoing pace of inflation. During both the second and third quarters of this year, the composition of real output shifted toward goods whose prices have risen relatively slowly. While the GNP implicit deflator is constructed with current-quarter weights, the Department of Commerce also computes a fixed-weight price index for GNP based on the composition of real output in 1967. This fixed-weight price index rose at a higher 2.9 percent annual rate in the third quarter, though still slightly below the second-quarter pace and well under the increase of most recent years.

Consumer prices turned in a less encouraging performance in the third quarter. Indeed, in September, large increases in food and apparel prices combined to boost the total consumer price index at a 5.5 percent seasonally adjusted annual rate. Based on quarterly averages of monthly data, the consumer price index advanced at a 3.6 percent annual rate during the third quarter. This was higher than the rise in the preceding quarter or, indeed, in the year that ended with that quarter. A spurt in food prices accounted for much, though not all, of the acceleration.

Large increases in agricultural prices similarly pushed up wholesale prices at a faster rate in the third quarter than in the preceding three-month period. At the same time, however, the rate of rise in wholesale industrial prices eased somewhat. Based on quarterly averages, these prices rose at a 3.8 percent annual rate in the quarter, down almost 1 percentage point from the previous quarter's advance. For the most part, this slowdown was centered in prices of producers' durable equipment and of intermediate materials, excluding foodstuffs. This easing became even more pronounced in October when seasonally adjusted wholesale industrial prices were reported

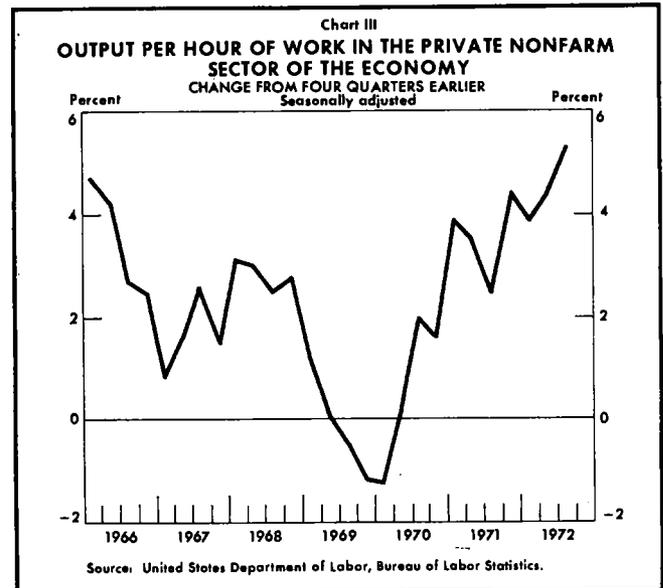
to have fallen at a 1.1 percent annual rate. A smaller than usual rise in new automobile prices along with a downward price adjustment for quality improvements in the new models accounted for the decline in the seasonally adjusted index of wholesale industrial prices. However, even excluding the prices of passenger cars, wholesale industrial prices still remained virtually unchanged in October. At the same time, there was only a small advance in wholesale agricultural prices on a seasonally adjusted basis, following several months of rapid increases.

WAGES AND PRODUCTIVITY

The rate of growth of wages was also relatively moderate in the third quarter. Within the private nonfarm sector of the economy, employee compensation per hour of work rose at a 5.9 percent seasonally adjusted annual rate in the July-September period. This advance was about equal to the average of the preceding three quarters and well below the growth rates experienced in recent years. Similarly, the mean first-year increase in wages and fringe benefits provided by new major contract settlements negotiated over the first nine months of the year, though still high at 8.5 percent, was considerably below the 13 percent mean rises recorded in 1970 and 1971.

Productivity in the private nonfarm sector turned in a strong performance in the third quarter, as seasonally adjusted output per hour of work rose at a 6.3 percent annual rate. This measure of productivity has been on a generally upward path since the beginning of 1970 (see Chart III). Over the last four quarters, output per hour of work has increased 5.3 percent. The third-quarter advance in productivity again outpaced the rise in compensation per hour of work, so that, for the second consecutive quarter, labor costs per unit of output in the private nonfarm sector registered a slight decline.

The pace of wage increases appears to have accelerated in the past two months. According to upward revised figures for September and preliminary data for October, average hourly earnings of nonsupervisory personnel in the private nonfarm sector, adjusted for overtime hours in manufacturing and for interindustry shifts in employment, rose at an 8.2 percent seasonally adjusted annual rate in these months. In contrast, the growth in these earnings had been an unexpectedly slow 3.5 percent annual rate between April and August of this year. While the September-October acceleration was widely distributed throughout the private nonfarm sector, the wage hikes of workers in both the services and the finance, insurance, and real estate categories were especially big,



exceeding 10 percent. However, even with this latest surge, the pace of wage increases has shown considerable moderation since wage controls were instituted. Thus, during the fourteen months since August 1971, average hourly earnings grew at a 6.2 percent annual rate, down almost a percentage point from the rate of growth experienced over the first eight months of 1971.

EMPLOYMENT

Further gains in employment were recorded in October. The poll of households conducted by the Bureau of Labor Statistics indicated that an additional 260,000 workers found employment in that month. While this was somewhat greater than the growth averaged in earlier months of the year, it was almost matched by an increase in the civilian labor force. As a result, the seasonally adjusted unemployment rate was unchanged in October at 5.5 percent. In its separate survey of employers, the Bureau of Labor Statistics found that employment in the private nonfarm sector expanded at a 5.3 percent annual rate in October, well above the 3.5 percent increase averaged over the first nine months of the year. In large part, this acceleration reflected the unusually rapid rise in manufacturing employment. At the same time, no change was reported in the workweek in either the manufacturing sector or the private nonfarm economy.