The Business Situation

The latest readings of the business situation point to a continuing rapid expansion in economic activity.[1] Consumers remain in the vanguard, as retail sales have posted exceptionally strong advances in recent months while purchases of new one-family homes have climbed to record levels. At the same time, there have been sizable increases in industrial production, in new orders for nondefense durable goods, and in inventory investment by manufacturers. Moreover, backlogs of unfilled durable goods orders and of unspent capital appropriations have risen, strengthening the basis for continued expansion of the economy. In conjunction with these developments, there has been additional improvement in labor market conditions, as evidenced by the further gains in payroll employment and by the fall in the unemployment rate to 5.2 percent in November.

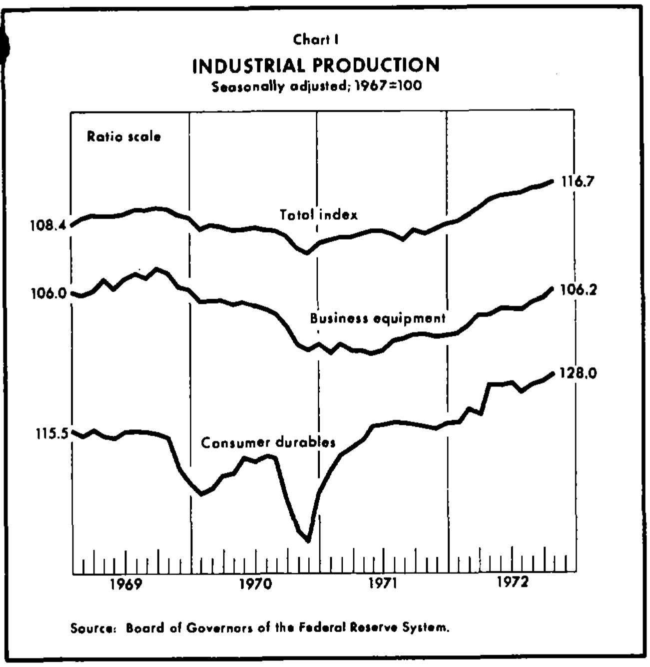
On balance, recent wage and price data suggest little change in the ongoing pace of inflation. The data continue to exhibit considerable month-to-month fluctuations. For example, average hourly earnings rose only modestly in November following two months of large increases. Wholesale industrial prices, on the other hand, posted a sizable increase in November after declining slightly in the previous month. Consumer prices as a whole rose in October at a rate slightly faster than the average monthly increase experienced during the earlier months of the year.

[1] The Department of Commerce has revised its estimate of growth in real gross national product (GNP) in the third quarter from a seasonally adjusted annual rate of 5.9 percent to 6.4 percent. The estimate of the increase in the fixed-weight price deflator for GNP was revised upward 0.2 percentage point to 3.1 percent per annum. Measured in terms of current dollars, there was a large upward revision in inventory investment which more than offset the modest reduction in the estimated rise in final expenditures. Profits before taxes advanced $4.2 billion in the third quarter to $95.8 billion at a seasonally adjusted annual rate.

PRODUCTION, ORDERS, APPROPRIATIONS, AND INVENTORIES

The Federal Reserve Board's index of industrial production rose at a very rapid 10.4 percent seasonally adjusted annual rate in October, bringing the annual growth rate to 9.5 percent for the first ten months of the year. The October advance was broadly based, with particularly strong gains in the output of business equipment and consumer durable goods (see Chart I). The increase in production of business equipment over the three months ended in October came to a 16.1 percent annual rate, more than double the rate of growth experienced in the earlier months of the year. All of the October expansion in consumer durable goods output was attributable to a large increase in the production of automotive goods. Domestic car production rose further in November to an annual rate of 9.8 million units on a seasonally adjusted basis, up about 8 percent from the October rate to one of the highest rates of output on record.

The seasonally adjusted flow of new orders received by durable goods manufacturers inched up by almost $200 million in October after having spurted in the previous two months. This data series is often quite volatile on a month-to-month basis, and recent movements have largely reflected unusually sharp fluctuations in new bookings for defense goods. A better indicator of the underlying orders situation is obtained by excluding defense bookings from the total. New orders for nondefense goods swelled 2.1 percent in October, slightly above the rate of growth experienced earlier in the year. Large increases in new bookings for nondefense capital goods and for automotive equipment swamped slight declines in orders for primary and fabricated metals. New orders for business equipment, in particular, posted a sizable 3.4 percent advance in October. Apart from a brief lapse during the June-August period, new orders for nondefense capital goods have strengthened considerably throughout the year, corroborating the results of the surveys of intended plant and



the Conference Board, these companies reported that their net new capital appropriations over the first three quarters of this year were 21 percent higher than those made in the same period of 1971. At the same time, these companies also reported that their actual capital expenditures were down slightly from last year's pace. Because all of this year's expansion in net new appropriations has been added to the backlog of unspent funds, it is likely that plant and equipment spending in the manufacturing sector will pick up in coming quarters.

Manufacturers have appreciably stepped up their spending on inventories since the middle of the year. In October, the book value of their inventories swelled by nearly $0.6 billion on a seasonally adjusted basis. The October increase was roughly in line with the large $1.9 billion advance posted during the third quarter and was well above the average monthly gain experienced over the first half of the year. Recent developments suggest that the long-anticipated acceleration in manufacturers' inventory investment may now be in progress. Between June and October, the increases in manufacturers' inventories have

equipment spending taken earlier in the year. Since new bookings for durable goods again exceeded shipments in October, the backlog of unfilled orders increased for the thirteenth consecutive month (see Chart II). Since the beginning of the year, the stock of unfilled orders has grown at a 16.1 percent seasonally adjusted annual rate, after having declined somewhat in 1971. This growth in unfilled orders portends a continuing expansion in durable goods production in coming months.

According to the results of the Commerce Department's latest survey, businesses increased their expenditures on plant and equipment modestly in the third quarter, raising them by slightly more than $0.5 billion to a seasonally adjusted annual rate of $87.7 billion (see Chart III). Businesses also reported that they were planning to boost these expenditures by about $10 billion over the next three quarters. Actual spending on these capital goods during the first three quarters of this year thus ran 8.2 percent above the average for the comparable period of 1971. This rate of growth is a bit more than 2 percentage points below the intended increase in these expenditures that was reported in the Commerce Department's earlier survey taken in January and February of this year. The shortfall between actual and intended spending has been centered wholly in the manufacturing sector, but improvements in that area may well be in prospect. For example, in a separate survey of the nation's 1,000 largest manufacturers conducted by

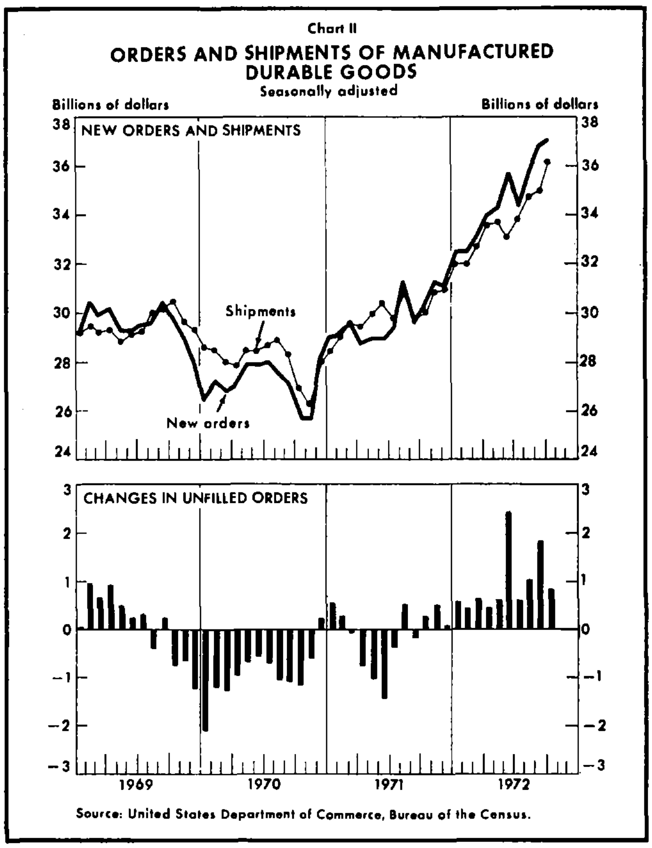
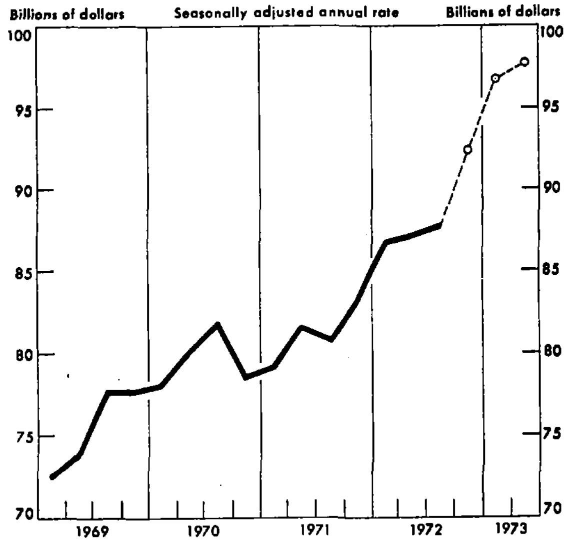


Chart III

PLANT AND EQUIPMENT EXPENDITURES

ACTUAL AND ANTICIPATED



Note: Figures shown for the fourth quarter of 1972 and for the first and second quarters of 1973 are estimates of intended spending from the October-November survey.

Source: United States Department of Commerce.

been fairly widely distributed among inventories at different stages of fabrication. Particularly notable has been the buildup in the stocks of materials and supplies, inasmuch as these inventories had actually been run down slightly over the first half of the year. In addition, results from the Commerce Department's quarterly expectations survey suggest that further inventory accumulation is in prospect. The proportion of manufacturers evaluating their stocks as relatively low has jumped sharply, while there are correspondingly fewer manufacturers reporting relatively high stocks.

PERSONAL INCOME, RETAIL SALES, AND RESIDENTIAL HOUSING

Personal income advanced by an unusually large $15.2 billion in October, rising to a seasonally adjusted annual rate of $962 billion. The 20 percent increase in social security benefits that became effective at the beginning of the month contributed nearly $8 billion to the overall advance. At the same time, the increase in wage and salary disbursements to workers in the private economy was slightly more than $1 billion higher than the average increment registered in earlier months of the year. This larger than average rise reflected the healthy gains in both employment and average hourly earnings in the private sector.

Consumption spending was also quite buoyant in October. Seasonally adjusted retail sales spurted $1.3 billion, more than recouping the decline that had occurred in the preceding month. Preliminary data indicate that retail sales in November held at about the October level. Over the first eleven months of the year, the annual rate of growth of retail sales was an estimated 12.9 percent, up from the substantial 9.9 percent rise recorded last year. The rapid expansion in total retail sales during the year has been broadly based among both durable and nondurable goods.

Activity in the residential housing market maintained its vigorous pace in October. Private housing starts rose slightly in that month to a seasonally adjusted annual rate of 2.4 million units, about equal to the average of earlier months in the year but considerably higher than the level averaged last year. The October advance was concentrated in multifamily units, which climbed to their highest level in eight months. Starts of single-family units fell slightly in October, as they had in the preceding month. At the same time, sales of new one-family homes have picked up somewhat in recent months. These sales rose to a record annual rate of 786,000 units in August and held there in September as well. As a result, builders' inventories of unsold new homes leveled off in September, following nineteen consecutive months of growth.

EMPLOYMENT AND WAGES

Conditions in the labor market apparently improved further in November. According to the survey of households conducted by the Department of Labor, overall employment rose only modestly in November but the civilian labor force declined substantially on a seasonally adjusted basis. Consequently, the rate of unemployment dropped to 5.2 percent in November, after having averaged 5.5 percent over the previous five months. While the drop in the unemployment rate to the lowest level since August 1970 was an encouraging development, it must be interpreted with caution. Curiously, the decline in the labor force was primarily among heads of households. The sharp decline recorded in this group's rate of participation in the labor force is an unusual development during an economic upswing and may reflect statistical problems. In any event, because these people are the primary source of income for their families, it is unlikely that they will remain outside the labor force for any extended period of time.

A less ambiguous indication of the strengthening of the labor market is provided by the separate survey of establishments, also conducted by the Department of Labor. According to the latest monthly poll, firms added more than 200,000 workers to their payrolls in November. The increase, which was about equal to the average gain recorded in earlier months of the year, was broadly based, with especially large gains in employment in the trade and manufacturing sectors.

The average hourly earnings of workers in the private nonfarm economy, adjusted for overtime in manufacturing and for shifts in the composition of employment among industries, rose at an annual rate of only 1.7 percent in November, down considerably from the 9 percent average increase of the two previous months. Throughout the year, this measure of hourly wages has fluctuated widely, varying from a rise of 10.6 percent at an annual rate in April to no change in May. In any given month the rate of change in average earnings is the result not only of the average size of wage increases but also of the number of workers who receive raises, which varies considerably over the year. While seasonal adjustment is intended to smooth out the differing proportions in each month, it may well be that the pattern of wage increases during the current year has been atypical. One reason could be the requirement of Pay Board approval before many wage increases are permitted to become effective. Consequently, it may be better to examine the growth in wage rates over periods of several months. The annual rate of growth in the adjusted average hourly earnings was 5.9 percent during the period of the Economic Stabilization Program from August 1971 through November 1972. By comparison, this measure of earnings had increased at a 7.1 percent annual rate over the first eight months of 1971.

PRICES

Consumer prices advanced at a seasonally adjusted 3.8 percent annual rate in October, down almost 2 percentage points from the spurt of the previous month. Marked decelerations in the increases in prices of both food and nonfood commodities underlay the October slowdown. However, the October performance of consumer prices may understate the ongoing pace of inflation. The deceleration in prices of nonfood commodities was in large part the result of the smaller than usual rise in new car prices, reflecting the postponement of some intended price increases pending the Price Commission's approval. (Increases approved by the Price Commission on December 1 to cover the cost of safety and pollution-control equipment installed by the two major manufacturers will not be reflected in the consumer price index until December or later.) The advance in prices of services accelerated in October. It should be noted, however, that part of this increase reflected an annual adjustment in the index for health insurance rates.

Wholesale prices turned in a rather disappointing performance in November. Large increases in the prices of both agricultural and industrial commodities combined to raise the overall wholesale price index at a 7.4 percent annual rate in that month. Agricultural prices spurted at an 18 percent annual rate, reversing the moderation in the rate of growth in the preceding month. At the same time, prices of industrial commodities registered a sharp 5.5 percent annual rate increase. This was the largest rise since August 1971, just prior to the imposition of the three-month wage-price freeze. However, inasmuch as these prices are often given to erratic month-to-month movements, it may be better to view the November advance from a somewhat longer perspective. Thus, the annual rate of growth in the prices of industrial commodities was 2.2 percent over the three months ended in November and 3.7 percent in the year ended in November. In each case, this represents considerable improvement over the rate of inflation prevailing for several months prior to the wage-price freeze.