The Business Situation

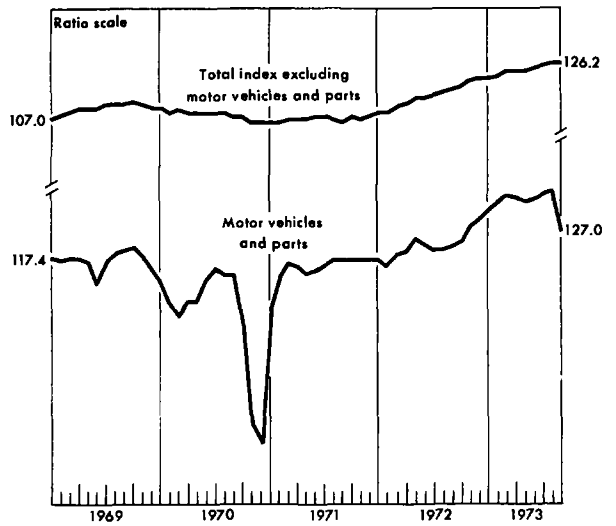
Recent developments suggest that economic expansion continues to be constrained by shortages and capacity limitations arising under the pressures of strong aggregate demand. Industrial production declined in August because of a sharp drop in the output of automobiles and trucks, in part resulting from materials shortages. With backlogs of unfilled orders still rising rapidly and the inventory-sales ratio for manufacturing continuing low, it is apparent that demand is straining productive capabilities. The latest Government survey indicates that businesses now anticipate even larger increases in expenditures on plant and equipment for the final quarters of 1973 than were previously reported. Retail sales remained high in August, as rapid increases in personal income helped to bolster consumer demand. Some buying, however, seemed to be related to attempts to beat expected post-freeze price increases. Only the housing sector has shown clear signs that a considerable slackening in activity is under way. While the unemployment rate held steady in September, the high level of job vacancies and increasing complaints that certain types of labor are in short supply suggest a tight labor market.

Soaring inflation in recent months has been marked by especially rapid increases in food prices. In August, the consumer price index rose at its most rapid rate in over twenty-five years, with food prices exploding at a 74 percent annual rate. At the wholesale level, prices dropped in September, as sharp declines in the prices of certain agricultural commodities led to a drop in the overall index at an 18.3 percent seasonally adjusted annual rate. Nevertheless, over the three months ended in September, wholesale prices rose at a 12.6 percent annual rate because of the overwhelming increase in prices of farm products, processed foods, and feeds. There are also indications that wholesale industrial prices have begun to rise rapidly again, especially in areas where demand is pressing strongly against capacity. At this point, the effects of rapidly rising wholesale food and other prices in earlier months are probably not fully reflected at the retail level. Moreover, while wage increases appear modest by comparison with the acceleration in prices, there are some tentative signs that the size of wage changes may be picking up.

PRODUCTION, ORDERS, AND INVENTORIES

During August, the Federal Reserve Board's index of industrial production edged down at a seasonally adjusted annual rate of 2.8 percent, registering its first decline since October 1971. This downturn was primarily the result of a substantial fall in the output of motor vehicles and parts. Such production, which accounts for about 5 percent of the total index, dropped 12 percent in August, the sharpest one-month decline since the 1970 automobile strike (see Chart I). Originally scheduled to exceed 10 million units at an annual rate, actual August output of domestic-type autos turned out to be at a much slower 8 million unit rate. The shortfall reflected the simultaneous occurrence of several unusual developments. Intensely hot weather covered much of the United States during portions of the month and hampered production by prompting scattered layoffs and plant shutdowns. The Canadian rail strike had an adverse impact on the output of domestic-type passenger cars, since there is a substantial amount of integration of auto production facilities between the United States and Canada. However, the major portion of the August setback resulted from shortages of a wide variety of automotive parts. Although production was proceeding at a brisk clip in early September, the seven-day strike at Chrysler held total September output to a 9 million unit annual rate, compared with rates of production averaging around 10 million units during the first half of 1973.

Excluding motor vehicles and parts, industrial production advanced at a 5.7 percent seasonally adjusted annual rate in August. Over the past six months, nonautomotive industrial production has advanced much more slowly



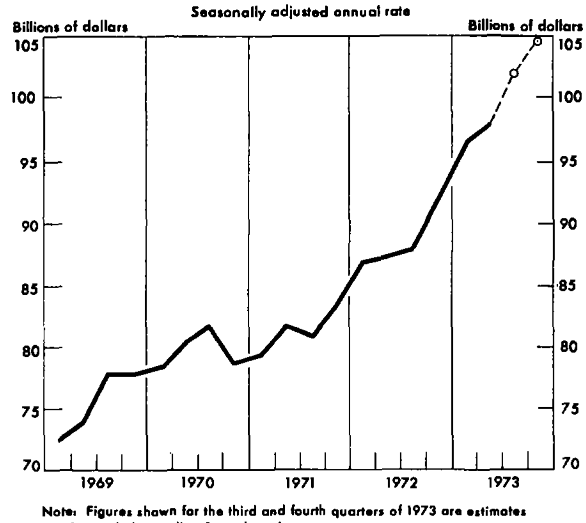
Source: Board of Governors of the Federal Reserve System.

than during the previous half year. Some of this moderation probably represents the impact of capacity constraints and supply bottlenecks in many important sectors of the economy. In any event, output of intermediate products rose sharply in August and output of business equipment increased modestly despite a decline in truck production.

Firms are planning to increase their plant and equipment spending in 1973 by 13.2 percent according to the Commerce Department survey taken during July and August (see Chart II). This was the same increase as reported in the April-May survey. Since actual outlays fell more than $1½ billion short of anticipated levels in the second quarter—at least partly as a result of supply problems—the most recent findings imply a substantial step-up in spending during the second half of this year. The April-May survey projected a 10 percent annual rate of growth over the last two quarters but the more recent estimates envision a 14 percent climb. If realized, the 13.2 percent rise in plant and equipment spending would make this the largest increase since 1966, when outlays surged 16.7 percent. Spending in nonmanufacturing industries is slated to rise by 9.9 percent, compared with the rapid 19.4 percent increase expected for manufacturing. A number of the industries that are facing capacity constraints, such as primary metals, textiles, and paper, have revised their plant and equipment spending plans upward.

Orders placed with manufacturers of durable goods fell by $0.4 billion (seasonally adjusted) in August, marking the second consecutive monthly decline. In July the cutback was centered in orders for defense goods, but bookings for these products rebounded substantially in August. A sizable increase in bookings for primary metals helped offset declines in other areas. Most of the August slowing in new orders occurred in nondefense capital goods industries, where bookings were unchanged from June to July. Over the first six months of 1973, orders for capital goods increased rapidly, however. The backlog for nondefense capital goods rose considerably in August and accounted for over 25 percent of the large advance in unfilled orders. More than 30 percent of the total existing backlog is centered in the primary metals industries where supply problems have persisted, nearly doubling the backlog during 1973. In August, shipments of durable goods declined following a rather large July increase, so that the ratio of unfilled orders to shipments increased to a new 1973 high of 2.61 months.

An indicator of broader coverage, the book value of seasonally adjusted business inventories, including all manufacturing and trade, increased $1.4 billion in July. In comparison, the average monthly increment in total business inventories was $1.9 billion over the first half



Note: Figures shown for the third and fourth quarters of 1973 are estimates of intended spending from the July-August survey.
Source: United States Department of Commerce, Bureau of Economic Analysis.

of 1973. The magnitude of these changes has been affected, of course, by the sharp intensification of inflation over the past seven months, and it appears that the physical volume of inventories has increased little. For example, during the first half of this year, the monthly book value increase in business inventories was well above the $1.2 billion increase averaged in the second half of 1972. However, the physical or real increase in inventories for the first half of 1973, as recorded in the national income accounts, was about half that of the earlier period. Another aspect of the current inventory situation which stands out is the persistently low level of the inventory-sales ratio by historic standards. Business sales advanced strongly during July, and the ratio of inventory to sales fell to 1.410, the lowest level since the early days of the Korean war.

Preliminary data indicate that manufacturing inventories rose by nearly $1 billion in August, a slightly larger increase than those registered on average over the first seven months of the year. At the same time, manufacturers' shipments dropped, in part because of the problems that plagued automobile producers in August, so that the inventory-sales ratio for manufacturing increased modestly.

CONSUMER SPENDING AND RESIDENTIAL CONSTRUCTION

Consumer spending has remained strong in recent months, with demand fueled in part by relatively large increases in personal income. Personal income rose $8.5 billion in July and $10.6 billion in August after registering average monthly gains of just over $7 billion during the first half of the year. While wage and salary disbursements have continued to advance strongly, farm proprietors' income increased by an unusual $0.8 billion in both July and August because of higher farm prices. In addition, transfer payments spurted in August in part through a cost-of-living adjustment applied to pensions of retired Federal civilian employees.

Retail sales rose by a very sharp 3.7 percent in July to $42.7 billion, following a decline between March and June, and remained at the high July level in August according to the advance report. In perspective, retail sales during August were 3.2 percent above the average of the second quarter, which had in turn shown virtually no increase from the January-March average. In August, sales of nondurable goods remained at the high July pace. Recent strong demand for home food freezers, undoubtedly connected with food stockpiling, has helped to boost sales in the furniture and appliances category which spurted sharply upward in August. Sales of new domestic-type autos slowed to a 9.7 million unit annual rate in August but rebounded to a very strong 10.6 million unit rate in September. Over the first nine months of the year, sales of domestic cars have been at a 10.1 million unit pace. The strong September pickup in sales is of note in view of the fact that dealer inventories were quite low, according to industry observers, with supplies of the popular small models especially tight. Sales of imported autos moderated to 1.7 million units (seasonally adjusted annual rate) in August and 1.5 million units in September, down from the previous two months and well under the historic high of 2 million units attained during February and March of this year.

Retail purchases have been facilitated, in part, by continued sizable expansion in consumer credit. In August, consumer credit outstanding rose by $2 billion, somewhat less than advances averaged over the first seven months of the year but still substantially above the average monthly increases of 1972. Increases in nonautomotive instalment credit and in automobile paper have been large in recent months, while the growth of noninstalment credit has moderated relative to its performance earlier this year.

The pace of housing activity continues to slacken. Housing starts dipped to 2 million units at a seasonally adjusted annual rate in August, off sharply from the historic peak of 2.5 million units achieved this past January. The August decline, which reduced starts to their slowest pace in almost two years, was concentrated primarily in single-family units. Newly issued building permits fell in August to an annual rate of 1.7 million, well below the December 1972 peak of 2.4 million. This marked the seventh decline in new building permits issued in the past eight months. Sales of mobile homes, which had been a rapidly growing component of the housing stock, have fallen for four consecutive months with seasonally adjusted July shipments of 569,000 at an annual rate, the lowest since last October. July sales of new one-family homes dropped well below the June pace, while inventories of unsold singe-family homes rose sharply to a record 8.8 months of sales.

All of these data were gathered before the Administration's mid-September announcements of proposed changes in national housing and home financing programs. Some of these proposals, such as lifting the interest rate ceilings on Federal Housing Administration (FHA) mortgages and instituting a tax credit for financial institutions on mortgage lending, require Congressional approval and thus are not likely to have an impact on housing in the very near term. However, the two major initiatives which can be implemented without further legislation—the expansion of the Government National Mortgage Association's capacity to purchase FHA-insured mortgages and the establishment of a $2½ billion program of forward commitments to savings and loan associations by the Federal Home Loan Bank Board—might help bolster housing activity in the future.

PRICES AND WAGES

The economy continues to feel the effects of the price advances originating in the agricultural sector. Consumer prices rose at a seasonally adjusted annual rate of 23.1 percent in August, the fastest increase in more than twenty-five years. Over the year ended in August, the consumer price index jumped 7.5 percent. This is much faster than the most rapid twelve-month increase recorded during the late 1960's and early 1970's—the rise of 6.4 percent over the year ended in February 1970. The index for food consumed at home exploded at a 92 percent annual pace in August, lifting such prices to a level 23.3 percent above that of a year earlier. Increases registered for poultry, eggs, and pork contributed substantially to the August advance. Even prices of fresh fruits and vegetables, items now in season, rose considerably on a seasonally adjusted basis, although they declined on an unadjusted basis.

A substantial rise in consumer food prices had been widely anticipated in light of previously announced increases at the wholesale level, but the August behavior of prices of nonfood consumer items, while less dramatic, is probably more surprising and complicated to assess. Nonfood commodity prices increased at a rapid 5.8 percent annual rate on a seasonally adjusted basis but only a 2.9 percent annual rate before seasonal adjustment. In view of the many changes in the Economic Stabilization Program over the past two years, it is possible that some usual seasonal patterns have been disturbed so that the unadjusted data should also be closely watched. Prices of services, which the Department of Labor does not adjust for seasonal fluctuation, rose at a rapid 7.8 percent annual rate in August, the sharpest advance since April 1970. An increase in mortgage interest costs accounted for a substantial portion of the upswing. Nevertheless, prices of other services, such as rents, medical costs, and telephone charges, also contributed to the increase in this measure.

Extraordinary variations in the wholesale price index have resulted over the past several months in part in response to changes in the controls program. Following a decline of about 17 percent in July, wholesale prices skyrocketed in August at a record 75 percent annual rate and then plummeted 18 percent in September, the largest annual rate of decline for any month since March 1946.

The amazing August increase was propelled by the more than 200 percent (annual rate) rise in wholesale prices of farm products, processed foods, and feeds. Declines in prices of major foodstuffs such as grains and livestock caused the September index to reverse direction and plunge at a record 62 percent annual rate. While the September decline may ease the severity of some price advances faced by the consumer, substantial retail food price pressures undoubtedly still exist. Despite the declines in July and September, prices of farm products, processed foods, and feeds have climbed at an annual rate of 32 percent since June to a level almost 40 percent higher than a year ago.

Wholesale industrial prices were essentially unchanged in July as a result of the freeze. They then rose at a 4.7 percent seasonally adjusted annual rate in August, and this was followed by a 7.9 percent jump in September. (Data unadjusted for seasonal variation show much the same pattern.) September's large advance brought the rise over the past year to nearly 8 percent. The hike in wholesale industrial prices in both August and September reflected increases in prices of metals, textiles, and lumber and wood products—industries in which supply constraints have been reported.

Wages have shown a comparatively modest response to the protracted acceleration in consumer price changes. However, there are some tentative signs that the size of wage increases is beginning to pick up. The index of average hourly earnings for private nonfarm workers is probably the closest approximation to basic wage rates available because it eliminates the effects of interindustry employment shifts and manufacturing overtime hours. Although the index is very volatile on a month-to-month basis, an examination of changes over the most recent six months shows that hourly earnings have increased at an annual rate of 7.4 percent, compared with a slower rise of 5.7 percent during the previous half year.

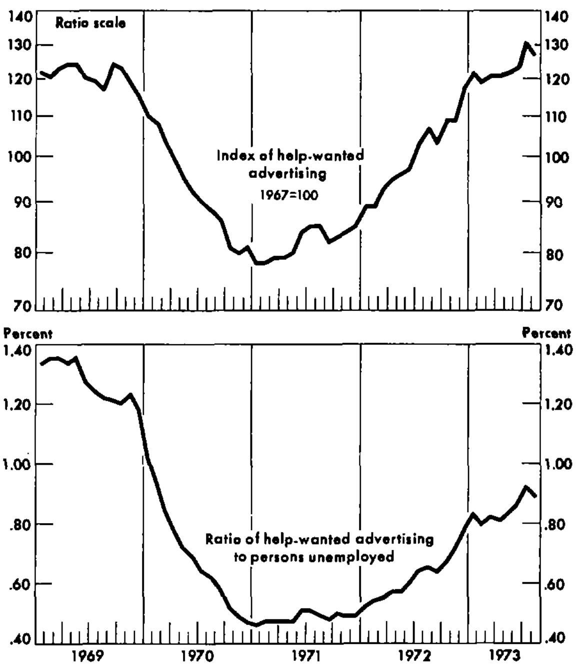
LABOR MARKET DEVELOPMENTS

Conditions in the labor market remain basically strong although, as is often the case with monthly statistics, some of the most recent evidence has been mixed. According to the survey of households, the civilian labor force and employment registered very large increases in September on a seasonally adjusted basis after contracting slightly in both July and August. Because data based on samples—even one as large as the household survey which encompasses some 50,000 households—can move somewhat erratically on a month-to-month basis, comparisons over longer time spans often help to give a clearer picture of the underlying situation. Over the year ended in September, the civilian labor force expanded by a very rapid 2.7 percent, while the total civilian population of working age increased by a considerably smaller 1.8 percent. The overall unemployment rate edged up from 4.7 percent in July to 4.8 percent in August, and this rate was maintained in September. However, the decline in the unemployment rate from the 5.5 percent level prevailing a year ago in the face of very rapid labor-force growth is significant both from the narrow technical standpoint and from the broader vantage point of assessing underlying economic developments.

Chart III

HELP-WANTED ADVERTISING IN NEWSPAPERS

Seasonally adjusted



Source: The Conference Board, Inc.

The separate survey of establishments revealed that the number of persons on nonagricultural payrolls rose by about 200,000 workers in both August and September following a small decline in July. This brought the advance over the past year to 2.6 million jobs. During the third quarter, employment growth in the major industries was particularly strong in services. Manufacturing employment, however, was essentially unchanged over the quarter after having increased by more than 900,000 over the preceding twelve months.

According to the Labor Department, the number of seasonally adjusted unfilled job vacancies in manufacturing was 191,000 in August, up sharply from 170,000 at the start of this year and 131,000 a year ago. This is consistent with reports of shortages of certain types of skilled labor developing in recent months. Over the past year the number of long-term job vacancies—those which have gone unfilled for a month or more—has risen 64 percent, compared with the 39 percent increase in shorter term vacancies over the same period. The Conference Board's index of the volume of newspaper help-wanted advertising is the closest available approximation to an all-industry gauge of job vacancies. In July the index jumped to a record 131 percent of the 1967 base and, while it slipped to 127 in August, it remained well above rates posted earlier in 1973 or in previous years (see Chart III). The ratio of this index to the number of unemployed persons, also indexed on a 1967 base, may be more suitable for comparisons spanning several or more years as it adjusts for labor-force growth. Since its trough in the first half of 1971, this ratio has risen rather steadily. Although the August ratio fell off somewhat from its July peak, it is higher than it has been in recent years but substantially below levels reached in the late 1960's.