

The Business Situation

The economy posted strong gains in the closing months of 1967 and continues to move ahead vigorously. Gross national product (GNP) rose substantially in the fourth quarter of 1967 despite cautious spending on the part of the consumer and a relatively small advance in Federal Government spending. While a substantial portion of the fourth-quarter increase in GNP was accounted for by a jump in the rate of inventory accumulation, virtually all the components of aggregate demand rose. The continuing strength of the economy is clearly evidenced by the strong December advance in industrial production, the sharp rise in new orders for durable goods, and the substantial growth of employment. At the same time, prices on both the consumer and wholesale levels continued to rise, reflecting persisting demand and cost pressures. Indeed, about half of the fourth-quarter increase in GNP represented price increases rather than a larger volume of real output.

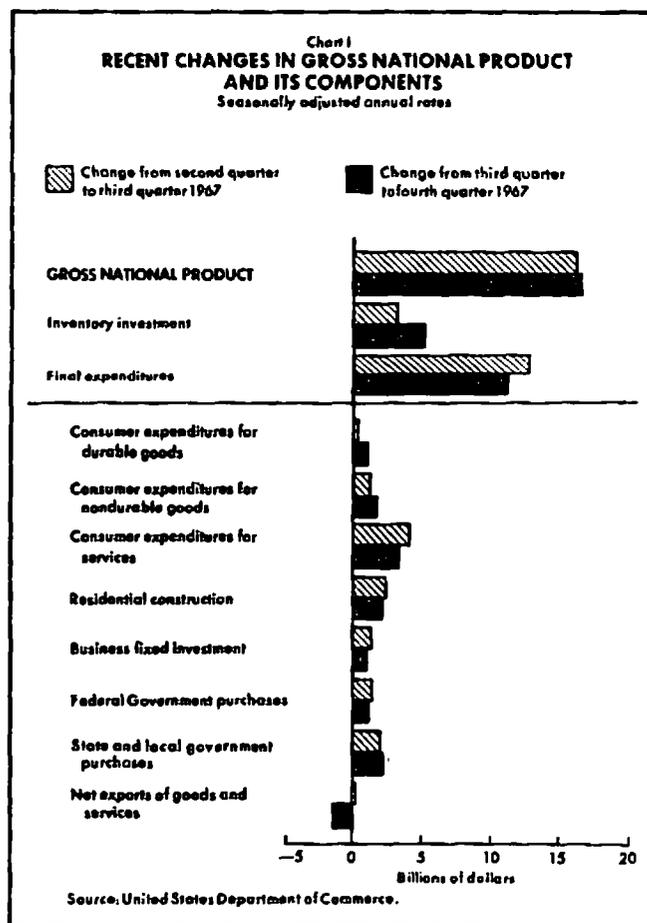
GNP IN THE FOURTH QUARTER

The nation's total output of goods and services increased by \$16.4 billion in the final quarter of 1967 (see Chart I) to a seasonally adjusted annual rate of \$807.6 billion, according to preliminary estimates by the Department of Commerce. This advance was the largest for any quarter since the beginning of 1966. During the second half of 1967, real output grew at a 4.5 per cent annual rate, sharply higher than the 1.1 per cent growth rate in the first half of the year. The substantial gain in real output in the second half was accompanied by accelerating price pressures. The GNP price deflator rose at an annual rate of 4.0 per cent in the period, nearly twice the first half's rate of increase and the sharpest six-month advance in the GNP deflator in more than a decade.

An unusually large rise in inventory investment accounted for more than 30 per cent of the fourth-quarter growth in GNP. Inventory accumulation increased to a \$9 billion annual rate from a \$3.8 billion pace in the preceding quarter. This gain was in marked contrast to the sharp drop in the rate of accumulation in the first half of 1967.

Fourth-quarter inventory growth reflected increases in trade stocks, as auto inventories were rebuilt, as well as a temporary increase in farm inventories.

In contrast, business spending on structures and equipment rose by a modest \$1.0 billion in the fourth quarter of 1967 to an annual rate of \$83.8 billion. The increase appears to have reflected higher prices for capital equipment, so that business fixed investment spending in real terms was stable at the third-quarter pace.



The continued growth of GNP has received only moderate support from consumer demand. The \$6.1 billion fourth-quarter increase in consumption expenditures was slightly larger than the quite modest rise in the preceding quarter. More than half of the advance was attributable to the growth of spending on services, with purchases of both durable and nondurable goods showing only small increases.

The strike-related slowdown in purchases of new automobiles was one factor restraining consumer spending. Auto sales in the fourth quarter were at an annual rate of only 7.3 million units, well below the 7.7 million annual sales pace during the first nine months of 1967. For 1967 as a whole, sales were 7.6 million units, considerably below the 1966 and 1965 sales figures of 8.4 million and 8.8 million, respectively. January sales, however, moved up substantially from the December level to an annual rate of over 8 million units.

Disposable personal income expanded by a healthy \$9.3 billion in the fourth quarter, and this in conjunction with the relatively slow growth in consumer spending meant that the savings rate climbed to 7.5 per cent, the highest since 1953. Contributing to the growth in income was a substantial year-end pay increase for both military and civilian employees of the Federal Government. The raise was retroactive to October 1, 1967, though it was not received by Government workers until late in December. This surge in income probably contributed to the sharp fourth-quarter rise in the savings rate, since it is likely that only a relatively small part of the retroactive increase was spent by the year's end.

Demand for housing has remained strong, and residential construction expenditures rose \$2.3 billion in the fourth quarter, reaching the highest level since the final quarter of 1963. To be sure, private nonfarm housing starts, which had risen rapidly in October and November, fell precipitously in December to 1.2 million units at a seasonally adjusted annual rate. However, housing starts are often erratic, and much of the December decline in starts may have been due to abnormally cold weather and snowstorms in the South and West. This explanation appears the more likely in view of the sharp December rise in the number of residential building permits issued, an activity which would not be significantly slowed down by adverse weather conditions.

Total government spending for goods and services boosted GNP by \$3.3 billion in the fourth quarter. However, Federal Government expenditures rose by only \$1.1 billion as the marked slowdown in the growth of defense spending, which became evident in the third quarter, continued in the final three months of 1967. Defense

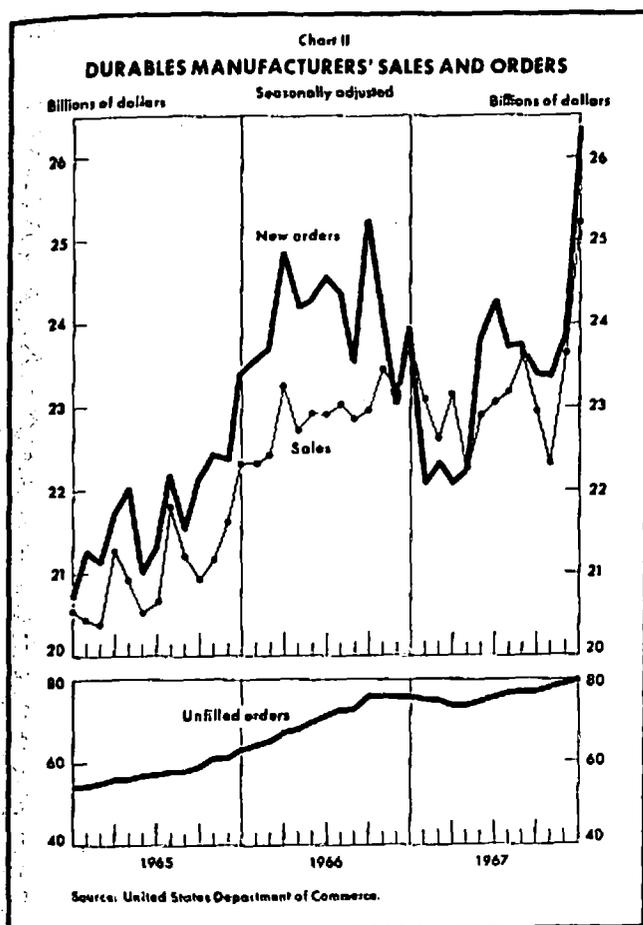
expenditures rose by a relatively modest \$1 billion, following an increase of only \$0.8 billion in the third quarter; the increase in the first and second quarters averaged, in contrast, \$3.5 billion. At the same time, the fourth quarter saw only a negligible rise in Federal Government purchases of nondefense goods and services. Indeed, the fourth-quarter increase in Federal spending is more than accounted for by the pay rise granted to Government employees late in the year. State and local government expenditures continued to expand in the fourth quarter at the high rate evident in the first three quarters.

Net exports of goods and services fell by an unusually large \$1.4 billion in the fourth quarter. Imports rose sharply, reflecting the rapid growth of aggregate demand and as well as special factors such as the long copper strike. Exports, on the other hand, did not rise during the quarter.

PRODUCTION, PERSONAL INCOME, AND EMPLOYMENT

In December, the Federal Reserve's seasonally adjusted production index jumped 2.3 percentage points to a new high of 161.6 per cent of the 1957-59 average, after showing a 2.7 percentage point gain in November. The strong upsurge in industrial production in the closing months of 1967 was in striking contrast to the performance of earlier months when production had been dampened, first by the largest inventory adjustment on record and later by labor disputes. Nearly half of the December increase in industrial production was accounted for by the motor vehicle and parts component, as auto producers tried to make up for production lost during the earlier strikes at Ford and Chrysler. In December, auto production reached 8.9 million units at an annual rate, but in January strikes at General Motors held back output so that auto production slipped back to an annual rate of 8.4 million units. Production of other consumer goods and of business equipment continued to expand in December. Materials production rose strongly, buoyed by the continuing surge in steel output. Increased production caused the manufacturers' utilization rate to edge up to 84.3 per cent of capacity in the fourth quarter, the first increase since the second quarter of 1966.

The volume of new orders received by manufacturers continues to increase. In December, new orders for durable goods shot up 12 per cent, the strongest advance since 1956. The December increase was broadly based, but gains in the steel, auto, equipment, and defense industries were particularly vigorous. Though durables shipments reached a record high in December, they were exceeded by the volume of new orders, and the unfilled orders backlog.



increased by another \$1.1 billion (see Chart II).

Rising economic activity as well as the Federal pay increase boosted December personal income, measured at a seasonally adjusted annual rate, by \$5.7 billion. While the main factor in the month's income growth was the pay rise, the brisk pace of industrial activity also led to higher employment and earnings and longer hours. The unemployment rate in December fell to an eight-month low of 3.7 per cent. The decline in unemployment was widespread, with the rates for adult men and women as well as teen-agers all dropping back to the levels of early 1967. The December decline brought the unemployment rate for the full year to 3.8 per cent, unchanged from the thirteen-year low set in 1966. Part of the December increase in civilian employment was due to a greater than normal rise in farm employment, caused by a late harvesting season. In addition, the number of persons on the payrolls of nonagricultural establishments advanced in December by 200,000 to reach 67.1 million (seasonally

adjusted), following an even larger increase in November.

Civilian employment grew by 1.5 million persons in 1967. As indicated by the nonfarm payroll survey, nearly all the 1967 rise in nonagricultural employment occurred in the nonmanufacturing sector. However, factory employment in both the durables and nondurables sectors showed strong gains in the fourth quarter, after declining throughout the first nine months of the year.

The civilian labor force rose by a record 1.6 million persons in 1967 to an average level of 77.3 million. In contrast to the experience of the past few years, when much of the increase in the labor force resulted from the entrance of teen-agers, all the 1967 increase was accounted for by adults—about 600,000 men and 1.0 million women. The teen-age civilian labor force was virtually unchanged because of increased military demands. The sizable expansion in the adult labor force in 1967 reflected the combined effects of population growth and a heavy demand for additional workers. The big population group born soon after World War II has now moved out of the teens into the early twenties. Approximately one third of the 1967 labor force growth took place in this age category. The sizable increase in the number of adult women in the labor force during 1967 was in part attributable to a change in the definition of the labor force as well as to the heavy demand for additional workers. The labor force participation rates of women, in contrast to those of adult men, tend to be responsive to overall demand conditions—rising in good times when the employment situation is favorable and declining somewhat in periods of slack.

COST AND PRICE PRESSURES

Labor costs continue to rise. According to the Bureau of Labor Statistics, collective bargaining settlements concluded in 1967 involved median wage and fringe benefit increases totaling 5.6 per cent a year, compared with an increase of 4.5 per cent in 1966. The rapid advance in labor compensation during 1967 was accompanied by a leveling-off in productivity growth, reflecting the sluggish behavior of manufacturing output during most of the year and the consequent decline in the utilization of manufacturing capacity. Output per man-hour in manufacturing in 1967 was only 1.0 per cent larger than in 1966, the smallest increase in the present expansion, and capacity utilization averaged only 85.1 per cent, the lowest level since 1963.

The combination of sizable wage gains and modest growth in output per man-hour resulted in a sharp increase in labor costs per unit of output. In December, the index of unit labor costs in manufacturing stood at 106.7 per

cent of the 1957-59 average, 3.6 per cent above December 1966. Between mid-1958 and mid-1966, unit labor costs in manufacturing were essentially stable. This was a major factor behind the general price stability of that period. The rise in unit labor costs over the past year and a half has generated pressures on businessmen to raise prices or to suffer declining profits. While productivity can reasonably be expected to move upward as the economy expands more vigorously, it is unlikely that the growth in output per man-hour will be adequate to offset mounting labor costs.

Increasing demand and cost pressures have already had an effect on the broad index of wholesale prices. In December, the wholesale price index jumped 0.6 percentage point to 106.8 per cent of the 1957-59 average, the sharpest

rise in eighteen months. While industrial wholesale prices rose by only 1.8 per cent over 1967 as a whole, price increases have been accelerating and industrial wholesale prices advanced at a 3.4 per cent annual rate in the fourth quarter. Preliminary figures for January indicate a continuing rise in wholesale prices. The total index is expected to increase another 0.3 percentage point as all the major components register advances.

In the consumer area, widespread price increases caused the consumer price index to advance a sharp 0.4 percentage point in December, the eleventh consecutive monthly increase. The consumer price index in December rose to 118.2 per cent of the 1957-59 base, a gain of 3.1 per cent over the year and the second largest annual increase since 1951.

The Money and Bond Markets in January

The money market was firm throughout January, with the effective rate for Federal funds remaining generally above the discount rate. Member bank borrowings at the Reserve Banks were reasonably steady after the first statement week, in which borrowings reflected the usual bank adjustments prior to the year-end statement date. Net free reserves were allowed to ride up and down to compensate for the shifting amounts of reserves retained by "country" banks. By contrast with the firm rates in the market for overnight funds, rates for most short-term debt instruments declined, reflecting an unusually large seasonal expansion in the volume of funds available for investment. Treasury bill rates declined sharply, despite the sale of an additional \$2.5 billion of June tax anticipation bills early in the month. Large commercial banks lowered their posted offering rates on new negotiable time certificates of deposit (C/D's), dealers in bankers' acceptances and in prime commercial paper reduced their offering rates, and major finance companies lowered rates for most maturities of paper which they place directly with investors.

Prices of intermediate- and long-term Government securities scored large gains during January. The market de-

veloped a buoyant tone at the beginning of the month, as hopes for peace negotiations on Vietnam blossomed and President Johnson announced a program designed to bring the nation's international payments into balance. Prices rose sharply until midmonth, when market hopes for early progress toward peace faded and the domestic fiscal and credit situation was interpreted as generally unfavorable. The brief downward movement of prices at midmonth was reversed toward the close of the month despite a variety of disquieting developments, including new tensions in Korea. The corporate and tax-exempt bond markets also displayed considerable strength early in January, softened around midmonth, and firmed near the close of the month.

BANK RESERVES AND THE MONEY MARKET

The money market was somewhat firmer, on average, in January than it had been in December, and the effective rate for Federal funds was generally at the 4½ per cent level attained late in the preceding month. Wide week-to-week variations in nationwide net reserve availability did