The Business Situation

Economic activity again expanded sharply in the second quarter of this year. Gross national product (GNP) valued at market prices increased just short of $20 billion, nearly matching the record first-quarter gain. Inventory investment contributed substantially to the latest growth in overall spending, however. Indeed, final expenditures—total GNP less the change in business inventories—advanced only half as fast as in the first quarter. Spending by consumers, which had been exceptionally strong in the first three months of the year, advanced slowly in the second quarter despite a further steep rise in disposable personal income. As a result, the personal savings ratio increased, reversing most of the decline in the preceding quarter and bringing the savings rate almost back to the previous peak level.

Prices of goods and services continued their sharp increase in the second quarter. The GNP price deflator—which gauges price trends throughout the economy—rose at a 4.0 per cent annual rate, in line with the excessive rise that began after mid-1967 when economic activity started to accelerate. The tax increase that became effective in July, coupled with the program of restraint in Federal spending, should help to remove some of the inflationary pressures in the economy originating from the demand side. However, much of the current upward thrust on the price level reflects increases in costs of production, especially wage costs. Indeed, negotiated settlements involving current and future wage raises far in excess of productivity gains continue to be the rule. These cost increases, in turn, are partly the legacy of earlier excess demand conditions prevailing much of the time since mid-1965 when the Vietnam military outlays began to increase sharply. Experience since World War II has shown that cost-push can be a particularly tenacious form of price inflation, and consequently substantial price rises must be anticipated for some time to come even if the dampening of demand materializes as expected. Meanwhile, the currently high level of savings gives consumers the option of absorbing part of the tax increase by reducing savings rather than spending. Also, the substantial decline in market rates of interest that accompanied the tax increase has buoyed the outlook for some types of spending, notably residential construction. Agreement on a wage contract in the steel industry without a strike removed some uncertainty about the economy in the months ahead, but the steel price increases announced immediately after the settlement underscored the inflationary cost pressures that now pervade the economy.

GROSS NATIONAL PRODUCT IN THE SECOND QUARTER

The nation's total output of goods and services increased by $19.6 billion in the second quarter (see Chart I) to a seasonally adjusted annual rate of $850.8 billion, according to preliminary Department of Commerce estimates. This advance amounted to 9.4 per cent at an annual rate, only slightly below the 10.0 per cent rate of gain of the first quarter when GNP increased $20.2 billion. Though price inflation accounted for more than 40 per cent of the second-quarter growth in the market value of newly produced goods and services, real output also expanded strongly at a 5.2 per cent annual rate. This real gain was less than the first-quarter rate of 6.4 per cent but otherwise the biggest increase since the end of 1966. Inflationary pressures remained strong in the second quarter. The GNP deflator rose by 4.0 per cent at an annual rate, a bit faster than in the first three months of the year. In the last four quarters, the deflator has risen overall at a rate of 3.9 per cent, the largest one-year increase since the year ended in the second quarter of 1957. The consumer price index has risen even more—registering a 4.2 per cent gain in the twelve months ended in June 1968, the most rapid one-year increase since early in the Korean war.

A large rise in inventory investment accounted for 32 per cent of the second-quarter GNP growth. Inventory spending increased to an $8.4 billion annual rate from the rather low $2.1 billion pace in the first quarter. This $6.3 billion step-up in inventory spending contrasted markedly with the $6.2 billion first-quarter drop. Strike-hedge steel buying and the buildup of larger than normal retail auto inventories undoubtedly contributed to the strength of total

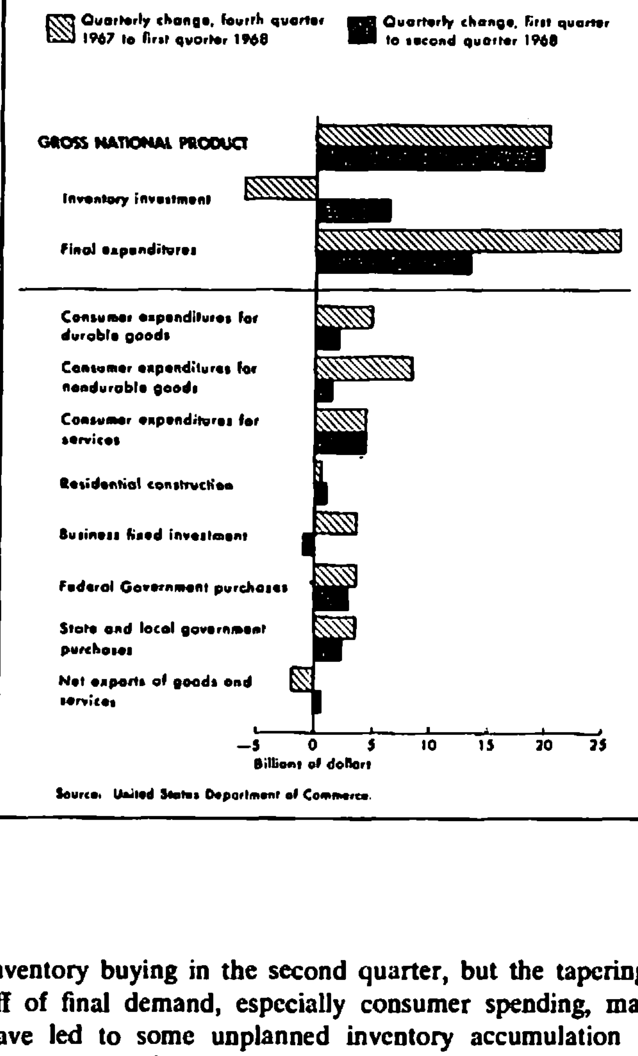


Chart I
RECENT CHANGES IN GROSS NATIONAL PRODUCT AND ITS COMPONENTS
Seasonally adjusted annual rates

Source: United States Department of Commerce.

inventory buying in the second quarter, but the tapering-off of final demand, especially consumer spending, may have led to some unplanned inventory accumulation if business sales fell short of expectations. Nonetheless, the level of inventories appears to be reasonably moderate, since inventory-sales ratios have remained at or near their relatively low first-quarter levels.

Business spending on structures and equipment weakened in the second quarter, dropping by $1.0 billion to an annual rate of $87.6 billion. This was the first decline in business fixed investment in a year, and was somewhat larger than had been projected in the May survey of plant and equipment expenditures conducted by the Department of Commerce and the Securities and Exchange Commission. The survey also found, however, that businessmen were planning modest increases in their plant and equipment spending during the remainder of the year.

Residential construction spending rose by $1.0 billion to an annual rate of $30.1 billion during the quarter just ended. This extended to five the number of consecutive quarters in which residential construction activity has increased, following the steep decline of building associated with shortages of mortgage financing in 1966. Moreover, while new residential housing starts and building permits declined in both May and June from their high April levels, the longer run outlook for residential construction has improved markedly in recent weeks as factors affecting the availability of mortgage finance have turned more favorable. The substantial decline since mid-June in both short- and long-term interest rates has increased the ability of nonbank thrift institutions (the principal mortgage lenders) to attract and retain deposit funds. At the same time, the improvement in yields on mortgage loans relative to yields on other long-term investments should encourage diversified institutional lenders to undertake more mortgage financing.

Consumers, whose spending had been the principal factor contributing to the record first-quarter GNP gain, reverted in the second quarter to the cautious spending patterns characteristic of 1967. Consumer outlays increased $7.7 billion, less than half the first-quarter gain of $17.2 billion and not much larger than the slow $7.1 billion average quarterly gain during 1967. Disposable income, on the other hand, continued to advance rapidly, registering a $12.0 billion increase in the second quarter. While less than the first-quarter rise of $14.8 billion, this income growth exceeded any of the quarterly gains recorded in 1966 or 1967. The large increase in consumption expenditures in the first quarter was accompanied by a drop in the savings rate and, conversely, with disposable income continuing sharply upward, the second-quarter slowdown in the growth in consumption spending was associated with a sharp rise in the savings rate. Savings increased to 7.7 per cent of disposable income from the first-quarter level of 7.1 per cent. The second-quarter savings rate was the second highest recorded since the end of the Korean war, exceeded only fractionally by the 7.8 per cent registered in the fourth quarter of 1967 when strikes in the automobile industry held back consumption spending.

Consumer purchases of durable and nondurable goods, which together had accounted for 75 per cent of the record $17.2 billion first-quarter advance in total personal consumption outlays, slowed sharply and accounted for only 44 per cent of the $7.7 billion second-quarter increase. On the other hand, consumer expenditures on services, which seldom show much departure from their upward trend, increased in the second quarter by $4.3 billion, unchanged from the first quarter. The modest second-quarter spending on durable and nondurable goods was reflected in a virtually unchanged level of monthly retail sales, from the high March total of $28.1 billion. Preliminary data indicate that June retail sales were $28.0 billion. Sales of domestically produced autos reached an annual rate of 8.4 million units in the April-to-June period, up 3.1 per cent from the first-quarter figure of 8.2 million units. Sales of imported cars also continued strong through the second quarter, raising the distinct possibility that imports will exceed the record 10.2 per cent market share achieved in 1959.

Total spending for goods and services by all levels of government contributed $5.1 billion to second-quarter GNP growth, rising to an annual rate of $195.6 billion. This gain, while down somewhat from the first-quarter increase of $7.0 billion, was about in line with the $5.0 billion average quarterly gain recorded in 1966 and 1967. The principal elements of the growth in government expenditures were a $2.5 billion increase in defense spending and a $2.3 billion rise in state and local purchases. Nondefense Federal spending edged up by a modest $0.4 billion, but a relatively sharp increase can be expected in the third quarter as the second stage of the previously legislated Federal civilian pay raise goes into effect.

RECENT DEVELOPMENTS IN PRODUCTION AND EMPLOYMENT

Industrial production in June rose to a record level for the second consecutive month. The Federal Reserve Board's index of industrial production advanced 0.3 percentage point to 164.4 per cent of the 1957-59 base, following a large 1.6 percentage point gain in May. But despite recent increases in industrial output, manufacturing utilization rates declined from 84.9 per cent in the first quarter of 1968 to 84.5 per cent in the second quarter, as growth in capacity outstripped gains in production.

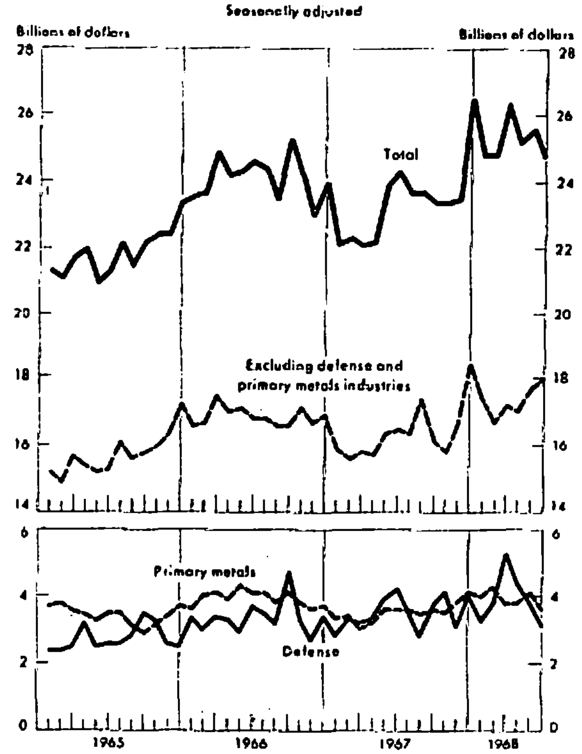
The June increase in output was led by gains in defense equipment production and in consumer goods output, particularly autos. Business equipment and materials output, on the other hand, held steady. Auto production has been very strong since May in preparation for the end of the 1968 model year. In June, auto assemblies rose to an annual rate of 9.4 million units, slightly above the high May rate, and July total production is scheduled to equal the heavy June pace, despite the production slowdown at the end of the month as model changeovers begin. Iron and steel output continued to rise in June, as steel mills worked to fill the high level of orders received in anticipation of a strike in August. Steel production in July climbed to 151 million tons at a seasonally adjusted annual rate.

Total new orders received by durables manufacturers fell by $767 million in June to a seasonally adjusted $24.8 billion (see Chart II), primarily as a result of sizable declines in new orders to the primary metals and defense products industries. Excluding these two components, new orders to durables manufacturers moved higher, with machinery and equipment orders showing strength. The rise in business machinery orders supports earlier survey reports that capital expenditures on plant and equipment would increase in the second half of the year. The sharp falloff in new orders for primary metals partly reflects the high level of steel inventories built up by steel users in anticipation of a steel strike in August, and the working-down of these large stockpiles should continue to dampen steel orders for several months. In addition, the decline in primary metals orders was associated with strikes at some aluminum plants. New orders to defense products industries have been declining since March, with the June level the lowest since November. Total shipments by durables manufacturers eased $0.1 billion from the record May level of $25.5 billion, and since shipments in the

Chart II

NEW ORDERS TO DURABLES MANUFACTURERS

Seasonally adjusted



Source: United States Department of Commerce.

month exceeded the flow of new orders, the backlog of unfilled orders dropped $0.6 billion to $80.3 billion.

Employment, like production, reached record levels in June. The civilian labor force, however, grew even more rapidly than employment, and the overall unemployment rate rose. Since both the surge in the civilian labor force and the 0.3 percentage point advance in the unemployment rate to a seasonally adjusted 3.8 per cent stemmed from an unusually large increase in the number of teen-agers and young adults seeking jobs, the higher unemployment does not seem to indicate any slackening in the economy. The end of the school year normally increases the number of persons unable to find work, but the June increase was larger than seasonal. As a result, the unemployment rate for teen-agers climbed 1.0 percentage point to 13.6 per cent, and the rate for 20- to 24-year-olds jumped 1.2 percentage points to 6.5 per cent. The unemployment rate for adult workers 25 and over, however, remained unchanged at 2.2 per cent. The rise in unemployment, thus, seems to reflect the difficulty of teen-agers and college students in finding employment. At the same time, the number of workers on nonfarm payrolls rose 82,000 to a record seasonally adjusted 67.9 million as increases were shown in all major industry groups except construction and mining. The weakness in construction employment and the very modest expansion of retail trade jobs probably contributed to the problems of youths looking for employment, since these industries normally employ many persons of such age groups.

PRICE AND COST DEVELOPMENTS

Both prices and costs advanced sharply in June, in most cases exceeding the already excessive average increases of the first five months of the year. The consumer price index, which moved up at an annual rate of roughly 4.0 per cent over the last several months, registered a 6.0 per cent annual rate of gain in June. All major components of the index showed substantial increases, but prices of services, which had risen at a 4.5 per cent annual rate in May, climbed at a steep 8.1 per cent annual rate in June. An important source of the higher services prices was housing costs which rose at an even larger 9.2 per cent annual rate.

Preliminary July data indicate that industrial wholesale prices, which were stable from April to June, rose at a modest 1.1 per cent annual rate in July, well below the increases of late 1967 and early 1968. However, prices of farm products and processed foods, which often fluctuate rather widely, turned sharply higher. Farm products prices rose at an annual rate of 16.4 per cent, and processed foods and feeds at a 13.6 per cent rate. Consequently, the overall wholesale price index rose at a 4.4 per cent annual rate, the biggest gain since February.

Moreover, trends in production costs threaten the recent comparative stability of industrial wholesale prices. Unit labor costs in manufacturing were up in June at an exceptionally high 9.8 per cent annual rate. The history of this series since the middle of 1966 gives a rather clear indication of an accelerating cost-push inflation. In midsummer 1966 the unit labor cost index was still within 1 percentage point of its 1957-59 average. In the following year, however, unit labor costs moved up 5.7 per cent, the most rapid sustained period of increase since the 1955-57 boom. Then, after leveling off considerably in the latter half of 1967, the series expanded at a 6.5 per cent annual rate over the first six months of this year. The large number of negotiated wage settlements in the 6 to 7 per cent range over the last few months suggests that this trend will be difficult to reverse in the near future.