The Business Situation

Current indicators of business activity remain strong on balance. On the plus side, industrial production increased in October while new orders for durable goods jumped almost 7 per cent. Nonfarm employment scored substantial gains during the month, unemployment continued at a low 3.6 per cent rate, and the volume of new housing starts and building permits, though fractionally lower than in September, remained at high levels. Also, recent surveys of business spending plans have pointed to an accelerated rate of increase in capital outlays next year. On the other hand, retail sales eased slightly again in October, and the rise in personal income was the smallest in nearly a year. Price increases have continued at an excessive pace. The rate of advance at the consumer level had moderated in August and September, but this was followed by a very sharp October increase. Moreover, industrial wholesale prices rose markedly in September and October, and advanced a bit further in November. The generally strong economic picture is reflected in continued heavy credit demands in the financial markets accompanied by higher levels of interest rates. The pressures on the financial markets were underscored in early December when most commercial banks throughout the country, faced with unexpectedly strong business loan demand and increased costs of loanable funds, raised the interest rate on prime business loans to 6½ per cent from 6¼ per cent.

OUTPUT, INVENTORIES, AND CONSTRUCTION ACTIVITY

Total industrial output rose in October for the second month in a row. The Federal Reserve Board's index of industrial production (seasonally adjusted) climbed 0.6 percentage point to 165.0 per cent of the 1957-59 average, following a 0.5 percentage point gain in September. The initial estimate of the September production index had shown a decline, but the figure has been revised upward by a full percentage point to reflect revisions in basic data on man-hours and output in selected industries—particularly nondurable materials and business equipment. Iron and steel output rose in October, and apparently the drag on total industrial production caused by the sharp cutback in the steel industry is over. The October index for iron and steel nevertheless was some 25 per cent below the level in early summer when users were stockpiling steel as a hedge against a possible strike. While most industry observers feel it will still be some time before the stockpiles are worn down enough to warrant a return to more normal production levels, preliminary data indicate that steel output rose substantially further in November.

The October strength in industrial production was centered in output of business equipment and consumer goods. Automotive products and some appliances, particularly television sets, contributed to advances in the consumer sector. Production of new automobiles rose to a seasonally adjusted annual rate of 9.2 million units, following a slight dip in September. Vigorous consumer and business demand has kept auto production climbing throughout most of this year, and preliminary data indicate that production held at the 9.2 million unit rate in November. Although output of business equipment advanced by about 1 per cent in October, production of defense equipment fell. Between mid-1965 and the beginning of 1968, output of defense equipment rose by 55 per cent, but there has been little further growth this year. Work stoppages in the coal industry resulted in a 4½ per cent decrease in mining output during October.

The near-term outlook for industrial production was strengthened further in October when new orders received by manufacturers of durable goods recorded a large and broadly based $1.9 billion rise, bringing the volume of orders (seasonally adjusted) to a record $30.3 billion. The advance followed on the heels of a strong September performance. Gains in orders were widespread among the major classes of durables manufacturers, with particularly large increases reported for machinery and equipment producers and for the defense-oriented industries. While shipments by durables manufacturers posted a sizable rise during the month, the increase was not nearly so large as the advance in orders. Thus, the backlog of unfilled orders expanded by a substantial $1.3 billion to a seasonally adjusted level of $81.9 billion.

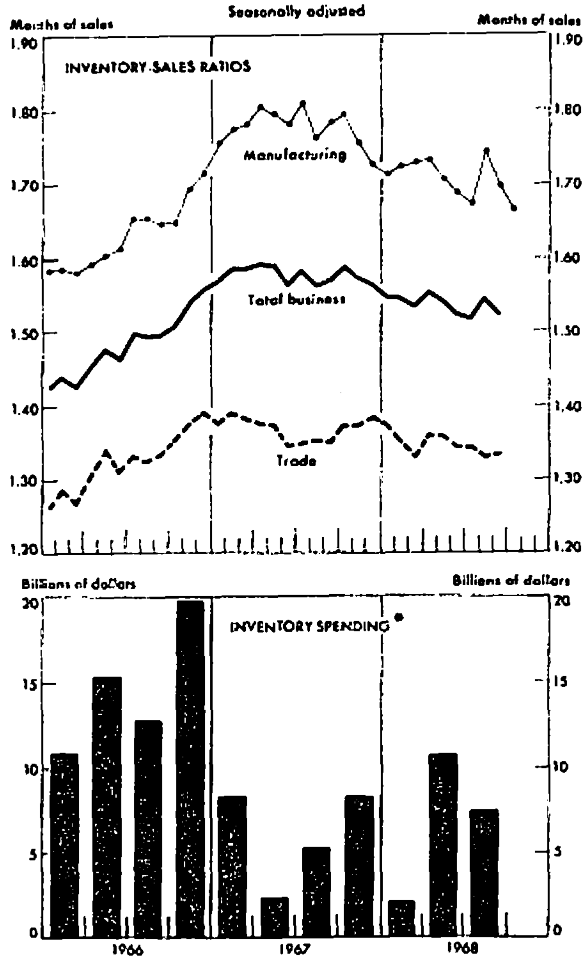
Total business inventory accumulation in the third quarter ran at a seasonally adjusted annual rate of $7.5 billion, as recorded in the gross national product (GNP) accounts.[1] Overall, this accumulation was right in line with sales, and the inventory-sales ratio for total business was virtually unchanged over the quarter (see Chart I). At the trade level, the surge of consumer demand in July and August apparently cut into inventory accumulation over those two months. In September, however, trade inventories advanced by $293 million, while sales by trade establishments increased only slightly. Thus, the inventory-sales ratio moved up a bit in September but remained below the July level. The large September increase in retail inventory accumulation was associated with a very strong rise in manufacturers' shipments. This shipments advance, combined with the continued working-off of steel inventories, held total inventory building in the manufacturing sector to a relatively normal $396 million. Thus, the inventory-sales ratio declined in September, reversing much of the August increase. In October, moreover, the inventory-sales ratio in manufacturing dropped sharply further to the lowest level in two years. Total manufacturers' shipments rose in the month by a very large $1.1 billion, with most of the gain occurring in durables manufacturing, while inventories advanced less strongly by $500 million.

The residential construction picture remains generally good even though new housing starts and building permits both dipped in October. The volume of building permits issued by local authorities had put in a healthy performance throughout the summer and then jumped 8 per cent in September. Thus, while permits eased by about 2½ per cent in October, they remained at a high rate. Much the same trend is apparent in the considerably more erratic series on new housing starts. During the third quarter, housing starts averaged a strong annual rate of 1.55 million units (seasonally adjusted), compared with 1.44 million during the spring. Following a sizable rise in September to a rate of 1.59 million units, the starts pace moved back in October to 1.55 million units. In view of recent performance, it now seems quite likely that starts

Chart I

INVENTORY-SALES RATIOS AND INVENTORY SPENDING

Seasonally adjusted



Note: The inventory-sales ratio for manufacturing is plotted through October; all other data are plotted through September.

* As recorded in the gross national product accounts at an annual rate.

Source: United States Department of Commerce.

will total more than 1.5 million units for the full year, compared with a 1967 total of 1.3 million.

BUSINESS INVESTMENT

Capacity utilization rates in manufacturing have weakened considerably since 1966, as expansion of facilities outstripped production growth. Not surprisingly, the volume of manufacturers' investment in plant and equipment, after adjustment for price increases, has fallen. Total capital spending by all business, on a real basis, also eased somewhat in 1967 and will increase only slightly this year, according to the survey of spending plans taken in Novem-

[1] The Department of Commerce has revised its preliminary estimate of third-quarter GNP, which was discussed in this *Review* (November 1968). Total GNP was revised upward by a slight $0.2 billion to a seasonally adjusted annual rate of $871.0 billion. Among the components, most changes from the first estimate were small. The net export figure, however, was revised up by $0.7 billion to a seasonally adjusted annual rate of $3.3 billion.

ber by the Department of Commerce and the Securities and Exchange Commission. In the third quarter, production declines in the steel industry and continued rapid growth of capacity caused a further easing of the capacity utilization rate, bringing it to the lowest level in five years. Nevertheless, capital spending appears to be strengthening. In manufacturing, the National Industrial Conference Board reported that net new capital appropriations rose strongly in the third quarter. Moreover, business spending plans for 1969 point to an increase of about 7 per cent in current dollar terms, according to a survey taken during the third quarter by the Lionel D. Edie Company and the more recent McGraw-Hill survey. A rise in capital outlays next year of around 7 per cent would be enough to insure a significant rate of real growth if capital goods prices continue to rise in line with recent trends. The newest Commerce-SEC survey of spending plans for the first half of next year is consistent with these earlier private surveys covering the full year. The Commerce-SEC study shows capital spending moving up sharply in the first quarter of next year and remaining at a high level in the second quarter.

The strength of capital spending in the face of relatively low utilization rates is striking in view of the current high level of interest rates and the trimming of corporate profits due to the surtax. In the third quarter, after-tax profits recorded a small $0.3 billion increase to a seasonally adjusted annual rate of $51.0 billion, compared with an advance of $1.6 billion in the previous quarter. However, these presumably dampening factors have apparently been partly offset by strong expectations of sustained real growth and rising capital goods prices, both of which have made it advantageous for businesses to plan over a longer time horizon. Tight labor market conditions are probably also causing producers to try to substitute capital for labor in the production process. Businesses have been adversely affected not only by the steep climb in labor costs but also by skilled labor shortages, which in some cases have actually held capacity utilization down.

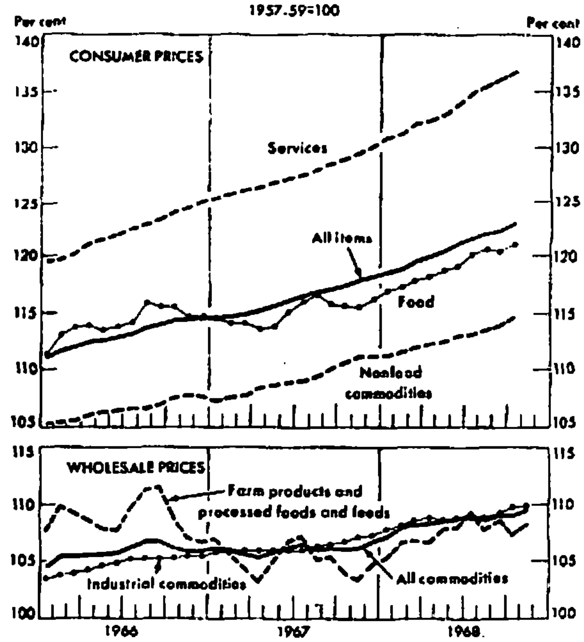
EMPLOYMENT, INCOME, AND CONSUMER DEMAND

Tight conditions continued to prevail in the labor market in October. The unemployment rate remained at 3.6 per cent, and nonfarm payroll employment recorded a substantial advance despite the two-week coal strike which cut mining payrolls by about 40,000. Gains were particularly large in manufacturing, trade, and state and local government. Although the rise in nonagricultural employment was sizable, agricultural employment declined sharply in October and total employment was thus unchanged. Reflecting this stability, aggregate personal income in October expanded by only $2.5 billion—about half the average monthly gain of the last year. This slowing in the rate of growth was centered in wages and salaries, which rose by $1.4 billion, compared with an average $3.7 billion increase in the last twelve months.

Total retail sales declined by about ½ per cent in October, following a similar drop in the previous month. The October decline was centered in automotive sales, which include dollar sales of used as well as new cars and of auto parts and repairs. On the other hand, unit sales of new cars reported by domestic manufacturers rose by 1 per cent during the month to a seasonally adjusted annual rate of 9.1 million units. The latest survey of consumer buying intentions, taken in October, suggests that consumer plans for buying new cars and other durables were virtually unchanged from those reported last July just before the increased withholding rates went into effect.

The unexpected surge in consumer spending during the third quarter was financed in large part by a record expansion of consumer credit. This trend continued in October when total consumer credit expanded almost $1.1

Chart II
CONSUMER AND WHOLESALE PRICES
1957-59=100



Note: Consumer prices are plotted through October; wholesale prices are plotted through November (preliminary).

Source: United States Department of Labor, Bureau of Labor Statistics.

billion, only slightly below the record gain posted in August. Instalment credit increased a record amount, as personal loans and loans to purchase automobiles were both particularly strong in October.

PRICE DEVELOPMENTS

Prices moved sharply higher in October. The consumer price index rose at an exceedingly rapid 7 per cent annual rate, to 122.9 per cent of the 1957-59 average (see Chart II). This advance followed two months of relatively small increases which had raised some hope that inflationary pressures were moderating at the consumer level. The October rise was particularly large in the indexes for medical care, apparel, household furnishings and operation, and transportation, which rose in response to higher new car prices. So far in 1968 the price rise at the consumer level has amounted to a 4.8 per cent annual rate, steeper than for any full calendar year since 1951. The picture at the wholesale level is not much better. To be sure, preliminary reports indicate that industrial wholesale prices increased only slightly in November. However, the limited size of the gain appears to have been due largely to major price cuts on selective steel products, and these cuts have since been rescinded by some major producers. Moreover, the November moderation followed a steep climb in each of the previous two months, when prices of hides, textile products and apparel, lumber, and steel all recorded big increases. The total wholesale price index advanced 0.4 percentage point in November, as the farm products component increased sharply and the processed foods and feeds component also rose.