The Business Situation

Economic activity continues to move ahead. According to the preliminary estimates of the Department of Commerce, the nation's real output of goods and services rose in the third quarter at the same rate as in the second, and the price level moved sharply higher. Inventory accumulation stepped up in the third quarter, while the growth of final sales was down somewhat—especially after adjustment for the nonrecurrent jump in Government spending resulting from the midyear Federal pay increase.

The various monthly indicators were generally mixed and difficult to interpret during the summer quarter but tended to take on a stronger cast as the fall season began. Housing starts, which have reflected the impact of this year's tight credit conditions more clearly than most other series, extended their downward trend through July and were about unchanged in August, but then recovered rather sharply in September. New orders for durable goods also showed little strength in July and August, but they too turned in a large and broadly based increase in September. At the same time, signs of an easing of inflationary pressures have remained elusive. The consumer price index rose sharply further in September, and industrial wholesale prices, which had climbed at an accelerated pace during the third quarter, turned in an October advance that was the most rapid in seven months.

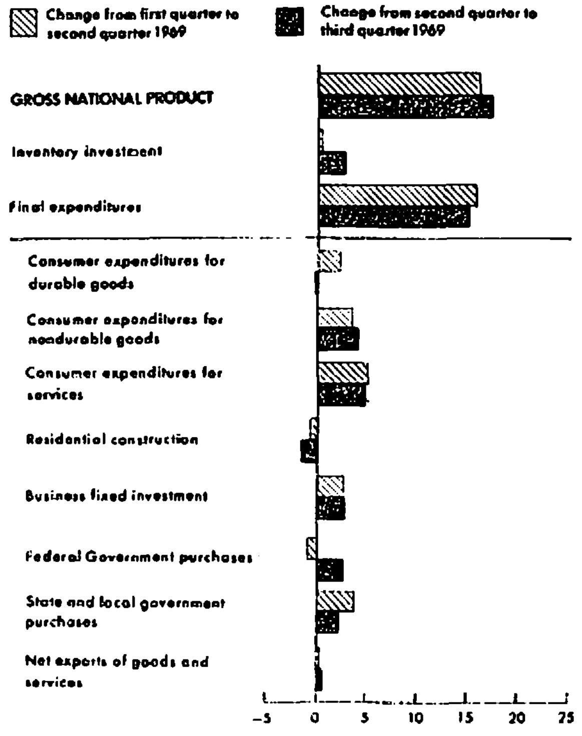
Taken together, the latest readings on the business situation present a stronger picture than was the case a month ago. However, as stressed in the last issue of this *Review*, statistical swings of this sort must be expected when an economy is operating at full capacity, particularly since there are inherent random elements in the statistics and all are subject to some measurement error as well. On balance, it appears that the basic economic situation has not changed significantly and that inflationary expectations are still dominant. Looking ahead, a major uncertainty is whether fiscal policy will continue to contribute to needed overall restraint in view of the scheduled termination of the 10 percent surtax and the pressures for increased domestic Federal spending.

GROSS NATIONAL PRODUCT IN THE THIRD QUARTER

The market value of the economy's total output of goods and services (GNP) increased by $17.5 billion in the third quarter (see Chart I), reaching a seasonally adjusted annual rate of $942.3 billion. The latest advance was a bit larger than the second-quarter gain of $16.1 billion, but the difference was more than accounted for by the July Federal pay increase, which directly added about $3 billion to the rate of Federal Government purchases. Real output—that is, GNP adjusted for price increases—rose at a 2 percent annual rate in the third quarter, equal to the gain registered in the second. The GNP price deflator—the broadest available measure of price trends in the economy—rose almost 5½ percent at an annual rate, compared with just over 5 percent in the previous three-month period. However, after allowance for the extra push exerted on the deflator by the Federal pay increase, the third-quarter rise came to about 4¼ percent, down from the first- and second-quarter pace but otherwise in line with earlier high rates of increase.

In terms of its composition, the most recent GNP gain was boosted by some step-up in inventory spending, while final sales rose more slowly, especially after adjustment for the effect of the Federal pay increase on the Government's purchase of goods and services. A drop in residential construction activity, little change in consumer spending on durable goods, and a much more moderate rise in outlays by state and local governments were the principal factors behind the slower growth of final purchases of goods and services. The acceleration in inventory spending in the third quarter gave rise to some upward movement in the ratios of inventories to business sales. However, the ratios in August did not appear particularly high in terms

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



Source: United States Department of Commerce.

of recent experience, and there are indications that September may have seen some downward movement.

Total consumer spending rose a modest $8.8 billion in the third quarter, less than in either the first or the second quarter, despite a record climb in disposable income. The weakness of consumer spending was centered in purchases of durable goods, as auto buying slackened a bit. Outlays for services continued their sharp climb, in part reflecting an especially rapid price rise, and consumption of nondurable goods was also up, about in line with the rate of gain in the first half of the year. At the same time, disposable income rose an estimated $16.8 billion in the third quarter, or nearly twice as much as consumer spending. The large Federal pay increase figured importantly in this surge of spendable incomes, but an even more important factor was the reduced flow of tax payments, following the completion in the second quarter of large final settlements on 1968 personal tax liabilities. Indeed, the growth of pretax personal income actually slowed in the third quarter despite the Federal pay increase.

Consumers are estimated to have saved nearly half of the third-quarter increase in disposable income. As a result, the saving-income ratio climbed by better than a percentage point to 6.4 percent, the highest reading in over a year. With saving already high relative to income, the 10 percent surtax scheduled to expire next year, and a large social security benefits increase virtually assured, consumer spending may strengthen in coming months. However, recent surveys of buying intentions have found the consumer to be cautious, while the trend of retail trade figures has shown little buoyancy for some time. Retail sales in the third quarter of the year were a bit below the level of the second quarter. Sales volume fell rather sharply in July, recovered about all of that loss in August, and according to the revised report turned down again in September despite a sharp temporary improvement in new car sales. Third-quarter sales of new domestic autos were at an annual rate of less than 8½ million units, off about ¾ percent from the second-quarter pace. Moreover, October deliveries dropped back to an annual rate of 8.3 million units after the surge to above 9 million in September.

Fixed investment spending by the private sector rose $1.1 billion in the third quarter. The nonresidential (business) component increased by $2.7 billion, but residential construction outlays dropped by $1.6 billion. The increase in business fixed investment was fully as large as that of the second quarter, and served to underscore the momentum of the plant and equipment spending boom that got under way in mid-1967. Recent surveys of businessmen's plans have indicated that capital spending will probably move higher in the next few months but at a slower pace than heretofore. A large September increase in new orders for machinery and equipment reinforces the likelihood of further near-term gains.

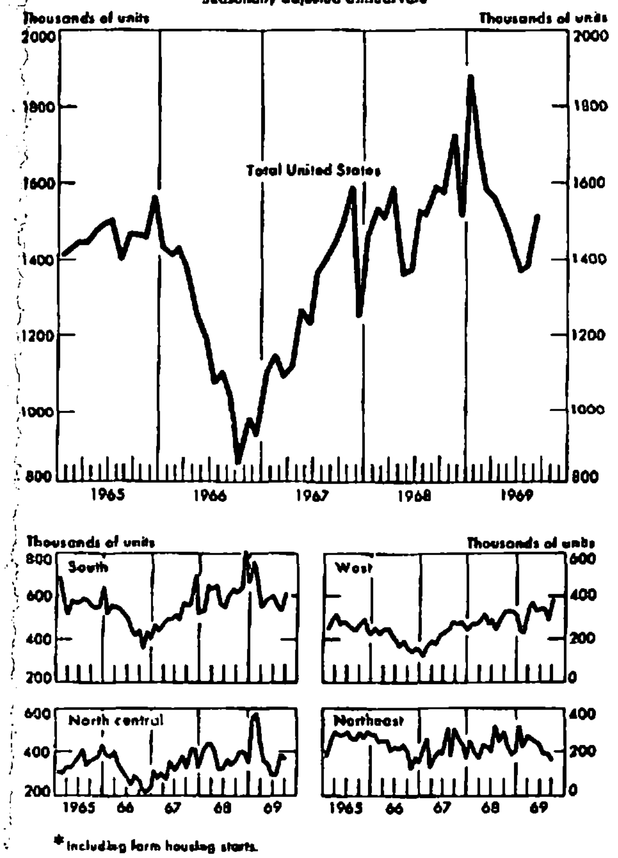
The third-quarter decline in home-building activity reflected the progressive downward movement of housing starts that has occurred this year. New private housing units were started at an annual rate of 1.7 million in the first quarter of the year, 1.5 million in the second quarter, and a still smaller 1.4 million in the third. However, the trend of housing starts did appear to strengthen as the third quarter progressed (see Chart II). Starts reached their low for the year in July at an annual rate below 1.4 million. They were then fractionally higher in August and up sharply in September to a pace of more than 1.5 million, the highest since April. However, building permits weakened further in September to their low point for the year, suggesting that starts in the next few months are unlikely to hold at their September level.

The geographic distribution of housing starts has been rather uneven in recent months (see Chart II, bottom panels). In the western region of the country, they are now at the highest level in several years and in the third quarter were up 15 percent from the same period of 1968. Starts in the north central states over the same period were off, but by only 3 percent, and the south experienced nearly as mild a decline—8 percent. In contrast, however, the northeast suffered a drop of fully 38 percent in private housing starts over the year ended this past quarter. The pattern of state usury laws limiting the maximum rate chargeable on home mortgages appears to have played a key role in this uneven national housing experience. The western states generally have the most liberal practice, whereas the usury ceilings in the northeast tend to be quite restrictive at today's interest-rate levels.

Chart II

NEW PRIVATE HOUSING STARTS*

Seasonally adjusted annual rate



*Including farm housing starts.

Source: United States Department of Commerce, Bureau of the Census.

As recorded in the GNP accounts, total purchases of goods and services by all levels of government rose $4.9 billion in the third quarter, the largest dollar increase in over a year. The Federal Government accounted for more than half of this spending surge. Both nondefense and defense spending moved higher, the latter quite sharply. However, but for the roughly $3 billion jump due to the pay increase, total Federal purchases would have been about unchanged. State and local governments increased their expenditures by $2.2 billion in the third quarter, the smallest gain in two years. This slowing followed three consecutive quarters of large gains averaging about $3.5 billion. It is likely that the exceptionally tight conditions that progressively developed in the tax-exempt bond market this year played a role in the recent slowdown of spending by state and local governments, since interest rates in the market frequently exceeded those which many of these governments may legally contract to pay.

PRODUCTION AND ORDERS

Industrial output declined somewhat further in September, on a seasonally adjusted basis. Following an August drop of 0.3 percentage point, the Federal Reserve Board's production index fell by another 0.5 point in September to an estimated 173.8 percent of the 1957-59 average. The downturn in August and September, which was the first two-month decline in industrial production since early 1967, almost exactly matched the July advance and thus brought the index for September to a level virtually identical to the June reading. The stabilization of business equipment production has been a factor contributing to the sluggishness of the overall index in recent months. Business equipment output rose sharply throughout the first half of the year, registering an advance from December to June of nearly 7½ percent at an annual rate. The following three months, however, saw virtually no change in the equipment index. The midyear shift from rapid growth to stability appears to have been centered in the output of commercial and industrial equipment, and thus may well reflect the more moderate rate of advance in planned capital spending.

The output of automobiles and related products dropped off in September to approximately the June level, while production of other consumer goods was about unchanged. The decline in the automotive sector, which accounted for a sizable share of the decrease in the overall production index, was largely traceable to work stoppages that cut into new car production. Domestic-model autos were assembled in September at an annual rate of just under 8.7 million units (seasonally adjusted), down from a bit more than 9 million in both July and August and a little above the June pace. Some strike activity continued to affect the auto industry in October. Though manufacturers' original schedules had pointed to a rise in the seasonally adjusted production rate, the assembly pace was in fact down from September.

Steel industry ouput, seasonally adjusted, edged up a bit in September after a steep drop in August, and production of materials was virtually unchanged on balance. The materials production index has been roughly stable since June, following a sizable advance from late 1968 through mid-1969. Through much of that period, a strong expansion in steel industry activity contributed significantly to the overall rise in materials output. While the rate of steel production remains high—indeed not far below the pace sustained through much of 1968 when users were hedging against a possible strike—it has drifted off since the spring, and October saw a further decline that about offset the small September rise.

A strong September increase has been reported in the volume of new orders for durable goods. Moreover, the figures for both July and August have been revised to appreciably higher levels, primarily because of large revisions in estimated ordering of transportation equipment. While the orders data still show a dip in August, the aggregate volume now estimated for the third quarter is substantially higher than the second-quarter figure, and bookings in September marked a new high by a sizable margin. The September advance resulted from an increased flow of orders over a broad range of durables manufacturing—with the notable exception of defense bookings which, after dropping steeply in August, edged off a bit further to a figure only marginally above the low June level. A sharp rise in orders received by the machinery and equipment industries marked a break from the general stagnation that had characterized that sector since the April bulge, which is generally thought to have been associated with the President's request for repeal of the investment tax credit. Shipments by durables manufacturers also moved to a new high in September, though the advance was smaller than that in new orders. Since the volume of bookings exceeded shipments, the orders backlog expanded to a figure very near the record established last spring.

PRICE DEVELOPMENTS

The rise in overall consumer prices accelerated in September. The aggregate index moved up at an annual rate of more than 5½ percent, somewhat above the third-quarter pace as measured from June to September though below the rate in the first half of the year. The September increase was dampened, relative to those of the preceding months, by a sharp reduction in the rate at which food prices advanced. The fact remains, however, that the month's small increase in food prices was counter to the usual seasonal pattern of a decline in September. Costs of consumer services continued to rise rapidly, and apparel prices, which usually increase in September, registered a more than seasonal gain. The prices of new and used cars in the September consumer index reflected the reductions posted prior to the introduction of the new models. Any actual increases represented by the prices of the new 1970 vehicles, after allowance for quality improvements, were not reflected in the September consumer price index but will influence the figures published for October.

Higher quotations for autos were a factor contributing to October's sharp advance in the wholesale price index for industrial commodities. With price increases recorded for a number of other nonagricultural goods as well, the rise in the industrial commodity index accelerated to an annual rate of more than 5 percent. At 113.7 percent of the 1957-59 average, the industrial index in October was 3.5 percentage points above the reading for last December—an increase of more than 3¾ percent at an annual rate. Following a sharp spurt in agricultural prices around midyear, the index for farm and food products has edged off a bit, largely because of a reversal in livestock prices. Despite a slight further decline in the agricultural index in October, the overall wholesale index rose at an annual rate of more than 3 percent.