The Business Situation

Recent business statistics have continued to indicate some slowing in the economy's rate of growth, although continued strength is expected in some key sectors. Industrial production has declined in each month since July, and residential construction activity has fallen since the beginning of 1969. In addition, consumer buying has been sluggish, and November retail sales were little changed from the levels of last spring. The price picture, however, shows no real slowing in rates of increase, and recent wage settlements are bound to result in significant boosts in unit wage costs. The outlook for the economy is rather mixed. Housing has been under downward pressure as a result of tight financing conditions, and auto production schedules have been cut back. Nevertheless, enactment of the tax reform bill, which includes a cut in the surcharge rate from 10 percent to 5 percent for the first six months of 1970 and elimination of the surcharge thereafter as well as an increase in social security benefits, will have a strongly stimulative influence on consumer income. Furthermore, most recent capital spending surveys point to rapid increases in plant and equipment purchases well into 1970.

PRODUCTION AND CONSTRUCTION

The Federal Reserve Board's index of industrial production declined in November for the fourth consecutive month, dropping by 1.2 percent to a seasonally adjusted level of 171.1 percent of the 1957-59 average. This was the largest monthly decline since the 1960 recession, but approximately one half of the November fall was attributable to the strike of about 150,000 workers at the General Electric Corporation. The cumulative decrease in output from the July peak amounts to about 2 percent, approximately the same percentage decline that had occurred in the first quarter of the 1967 mini-recession.

The General Electric strike had its major impact in the business equipment sector, where output fell in November after expanding at an annual rate of almost 7 percent in the first ten months of 1969. In view of the strength of near-term capital spending plans, however, growth of output in this sector could well return to a rapid pace after settlement of the strike. After edging down from July to October, the production of materials registered a sizable decline in November. This largely reflected reductions in output of electronic components (General Electric) and auto parts included in the materials index. Iron and steel output, which grew rapidly in the first half of 1969, has remained about constant at the level it fell to in August. While seasonally adjusted data on steel ingot production indicate that output in December was up slightly, iron and steel industry observers say that production may soon be cut in response to reduced demand from the auto sector.

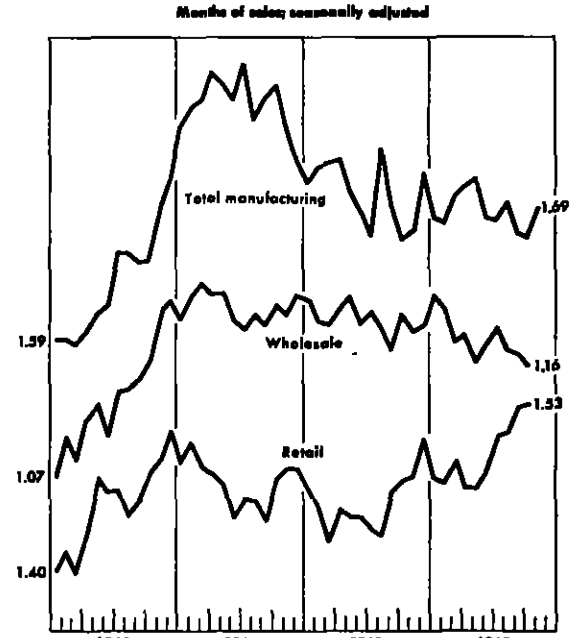
Consumer goods output fell 0.7 percent in November chiefly because of a large drop in the output of automotive products. Several major auto producers cut overtime and shut down for several days in order to reduce inventories. On a unit basis, car assemblies dropped off sharply from a seasonally adjusted annual rate of 8.4 million in October to 7.9 million in November. Moreover, General Motors and Chrysler had additional shutdowns in December, and total domestic auto assemblies on a seasonally adjusted basis declined further to 7.2 million units. First-quarter 1970 production schedules of these two producers have also been cut back. The General Electric strike was another important factor in the November decline of consumer goods production.

Residential construction has been under severe downward pressure, as mortgage market conditions have become steadily tighter. Private nonfarm housing starts in November at 1.27 million housing units, on a seasonally adjusted annual basis, were almost 15 percent below the 1968 average. Starts in all types of housing and in all regions except the South decreased in that month. The short-term outlook is for continued downward pressure on the residential construction sector. The number of newly issued local building permits for private bousing units has dropped at about the same percentage rate as actual housing starts: the November level was almost 14 percent below the 1968 average; in addition, the dollar value of residential construction contracts, as reported by F. W. Dodge, dropped in November and the average level from June to November was 10 percent below the average in the first half of 1969. However, the increase in the legal ceiling rate on mortgages insured by the Federal Housing Authority and those guaranteed by the Veterans Administration from 7½ percent to 8½ percent, combined with a large backlog of unutilized building permits, may have a favorable effect on bousing starts in the forty states that do not have legal maximum interest rates applicable to Government-backed mortgages.

Chart I

INVENTORY-SALES RATIOS

Months of sales; seasonally adjusted



Note: The ratios for wholesale and retail are plotted through October. The ratio for total manufacturing is plotted through November.

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

ORDERS, INVENTORY ACCUMULATION, AND CAPITAL SPENDING

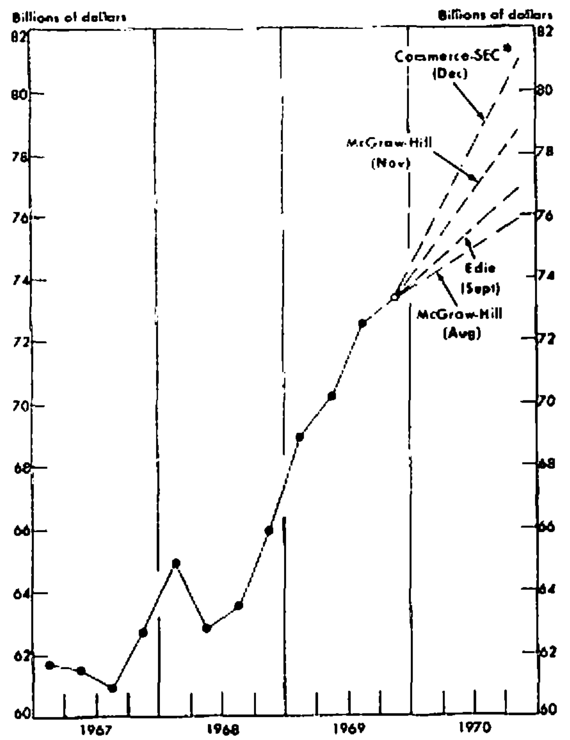
New orders received by manufacturers of durable goods have, on the average, been trending upward, although during 1969 the growth rate was somewhat less rapid than in 1967 and 1968. Moreover, since prices have risen substantially, the 1969 increase in the volume of orders in real terms has been considerably less than the increase in dollar volume. In November the orders series fell $0.7 billion despite an increase of $0.3 billion in defense bookings. Monthly figures are often volatile, but November declines were widespread, with electrical machinery, auto, and primary metals manufacturers experiencing exceptionally large reductions in the inflow of orders.

Although total business inventories have been rising at rates wbich appear pretty much in line with total sales growth, this has not been true for all sectors (see Cbart I). In October, total manufacturing and trade inventories advanced $1.4 billion, with both manufacturing and retail levels continuing their rapid rates of accumulation. At the manufacturing level, there was a sizable increase in sales and the inventory-sales ratio registered a slight decline. November data on the manufacturing sector, however, indicate that sales fell 1 percent entirely because of a decline in durables shipments. Meanwhile, inventories rose $450 million, again all in the durables category, and the inventories-sales ratio increased but remained well within the range of recent years. Moreover, at the wbolesale level, inventory accumulation has been negligible and the inventory-sales ratio has been relatively low lately. Data for retail stores in recent months, however, suggest some imbalance between inventories and sales. For both durables and nondurables retailers, inventories since the summer have been greater, relative to sales, than in the past few years. In the auto industry, where sales have been particularly weak, dealers' stocks have been rising at a fast pace since July, and the inventory-sales ratio for other durables is higher than at the beginning of 1969. At retail outlets for nondurable goods the October surge in sales caused a fairly significant drop in the inventory-sales ratio, but the ratio still suggests the existence of surplus inventories.

Despite falling profits and exceptionally tight conditions in money and capital markets, businessmen are currently undertaking and planning for enormous amounts of plant and equipment investment. The Department of Commerce and the Securities and Exchange Commission revised upward their estimate of fourth-quarter plant and equipment expenditures, and an increase from the third quarter is now indicated rather than the leveling expected earlier. According to this estimate, plant and equipment spending in 1969 was $71.3 billion, 11.2 percent above the 1968 rate. Furthermore, as the end of 1969 approached, successive surveys of capital spending have tended to forecast increasingly higher plant and equipment outlays for 1970 (see Chart II). In August, the McGraw-Hill survey projected 1970 expenditures of $74.9 billion. Lionel D. Edie & Co., Inc. estimated, in September, that 1970 expenditures would average $75.5 billion. In October, the McGraw-Hill fall survey reported business plant and equipment purchases of $76.7 billion for 1970, and in December the latest Commerce-SEC survey projected $78.1 billion for 1970, a 9.7 percent increase over the 1968 level. An earlier Commerce-SEC report indicated that growth in the first half of 1970 would be particularly strong. While some of the increase in expenditures will undoubtedly be absorbed by the higher prices that are anticipated, this estimate nevertheless implies that plant and equipment purchases in real terms will be substantially above the boom levels of 1969. According to McGraw-Hill, the advance in real spending reflects businessmen's desires to cut steeply rising unit production costs by modernization as well as their carryover of some unfulfilled 1969 plans into 1970. Of course, not all sectors are planning equally large expenditure increases. Commerce-SEC indicated that it was the nonmanufacturing sector that was planning a more rapid expansion, with public utilities—currently under severe capacity constraints—planning a 15 percent annual jump in plant and equipment expenditures. In the manufacturing sector, purchases are expected to rise at a slower rate than they did in 1969, but record-level investment spending will still be undertaken. While manufacturers appear to have ample capacity, they report expectations of fast demand growth in 1970 and thereafter.

Chart II

ACTUAL AND ANTICIPATED PLANT AND EQUIPMENT SPENDING



* The November Commerce-SEC survey indicated that most of the growth is slated for the first half of the year rather than being spent evenly throughout the year as shown in this chart.

Sources: United States Department of Commerce, Securities and Exchange Commission, McGraw-Hill Inc., and Lionel D. Edie & Co., Inc.

EMPLOYMENT, PERSONAL INCOME, AND RETAIL SALES

Although the unemployment rate in November and December at 3.4 percent was close to record-low levels, other indicators suggest some easing in labor market conditions. In November the percentage of covered persons receiving unemployment insurance benefits rose and the index of help-wanted advertising fell. The decline in average hours worked also suggests eased conditions: the average workweek for factory workers fell 0.3 hours to 40.5 hours in October and edged up slightly in December, while overtime hours in November were down for the second consecutive month. Furthermore, according to the payroll survey, employment has been growing more slowly in recent months. Nonagricultural employment, which was increasing at the fast rate of 238,000 persons per month during the first half of the year, has been rising by only 57,000 persons per month since June.

Personal income has been growing at a considerably slower rate in recent months, reflecting major work stoppages as well as easier labor market conditions and declining corporate profits. In the first half of 1969, personal income increased at an annual rate of 8½ percent, whereas since June the rate has been about 6½ percent. During November the General Electric strike reduced incomes by $1 billion and the net rise in total personal income was only $3.2 billion. However, even after adjustment for the effects of the strike, there appears to have been some slowing of the growth rate in October-November. Lately wage and salary income increases, in particular, have moderated, as gains in the number of payroll jobs have become smaller and the average workweek has fallen.

Another indication of slowing in the economy is the volume of retail sales, which has shown no significant change since the spring. Sales rose 1 percent in October, then declined a bit to $29.5 billion in November, a level only about ½ percent above that registered in the spring. Since December 1968, dollar volume has increased only 4.2 percent, less than the 5 percent rise in consumer goods prices. While the dollar volume of nondurables sales was about constant in November, durables sales turned down, with almost all the decline attributable to a fall in automotive group sales. On a seasonally adjusted annual basis, domestic new car sales were 8.3 million units in November, down from 8.4 million in October, and the data show a further decline in new car sales to 7.7 million units in December. Preliminary December data for total retail sales indicate little change from November. The outlook for consumer demand is unclear. While the Michigan Survey Research Center reported the third consecutive quarterly decline in the index of consumer sentiment, the new tax and social security provisions will certainly bolster consumer income and perhaps also consumer eagerness to buy.

Despite the current slowing of economic expansion, prices have continued to increase rapidly at both consumer and wholesale levels. Consumer price rises have been excessively large, averaging 6.0 percent (annual rate) in 1969 through November as compared with 4.7 percent in 1968 and 3.1 percent in 1967. There appears to be no real slowing of price increases, although some comparisons may suggest a moderation. From June to November, the consumer price index has risen at an average annual rate of 5.5 percent, lower than the 6.3 percent rate experienced in the first half of 1969. The average annual rate of price increase in the last six months for which data are available (May through November), however, is about the same as in the first five months of 1969. Moreover, consumer prices were rising at a 6.5 percent rate in November.

At the wholesale level, also, recent price advances have been large. Wholesale industrial prices rose at a 4.2 percent annual rate in December, resulting in an average annual rate of change in prices of 4.9 percent during the fourth quarter of 1969. The overall rise in 1969 was 4.0 percent, compared with 2.6 percent in 1968 and 1.8 percent in 1967.

Meanwhile, rising wages and lagging productivity continue to put upward pressure on prices. In the manufacturing sector, labor cost per man-hour rose at an annual rate of almost 4 percent in November, while output per man-hour fell 4 percent; hence, the labor cost of producing a unit of output increased at an annual rate of 8 percent. Rapid rises in the labor cost of production have been common in recent months: from June to November, unit labor cost in manufacturing increased at a rate of 7 percent, compared with only 2 percent in the first half of 1969. Moreover, recent and prospective large wage settlements will undoubtedly result in a significant rise of unit labor costs in 1970.