The Business Situation

The business expansion gained increasing strength during the summer months. Housing starts rose strongly in July, industrial production advanced for the first time this year, and the backlog of unfilled orders in durables manufacturing reached a new record high. At the same time, personal income increased substantially, and preliminary data indicate that retail sales turned in another strong advance. In August the unemployment rate dropped for the second month in a row as employment—notably in manufacturing—recorded a large rise. Along with the quickening pace of business activity, price increases on both the wholesale and retail levels are accelerating and again pose a threat to the orderly growth of the economy. Although it is difficult to assess at this time the impact on the economy of the automobile strike, which began as this *Review* went to press, it seems likely that the strike will only temporarily moderate the business expansion.

PRODUCTION, INVENTORIES, AND ORDERS

Industrial activity increased in July, following six months of virtually uninterrupted declines. The Federal Reserve Board's seasonally adjusted production index rose by a full percentage point—to 156.3 per cent of the 1957-59 average—recouping one fourth of the overall decline in the index from its December peak of 159.0 per cent. While the July upturn reflected improvement in the general pace of industrial activity, a good part of the increase was due to the settlement of strikes in the rubber and electrical machinery industries and the surge in domestic crude oil output following the curtailment of supplies from the Middle East. In terms of broad market groupings, production of materials, equipment, and consumer goods all rose from the June levels.

In the consumer sector, output of automotive products increased once again in July, continuing the advance from the low mark reached in February. On a seasonally adjusted basis, the production of new cars rose by about 1½ per cent to an annual rate of just over 8 million units. While output slipped a bit in August, preliminary schedules for September had indicated an unusually large rise in automobile assemblies. However, the strike against the Ford Motor Company—which manufactures about 25 per cent of the nation's cars—will hold production below scheduled levels.

Output of consumer goods other than automobiles was about unchanged in July from the May-June pace. Declines in the apparel and furniture indexes were offset by gains stemming from the settlement of a strike against a major television set producer, as well as by increases in output of other appliances. As a result of the January-May sluggishness in retail demand and of the sizable inventories that existed earlier in the year, production of nonautomotive consumer goods has shown little buoyancy in the past few months. However, the recent pickup in retail sales, coupled with an improved inventory situation, points to a likely strengthening of activity in industries producing for the consumer market.

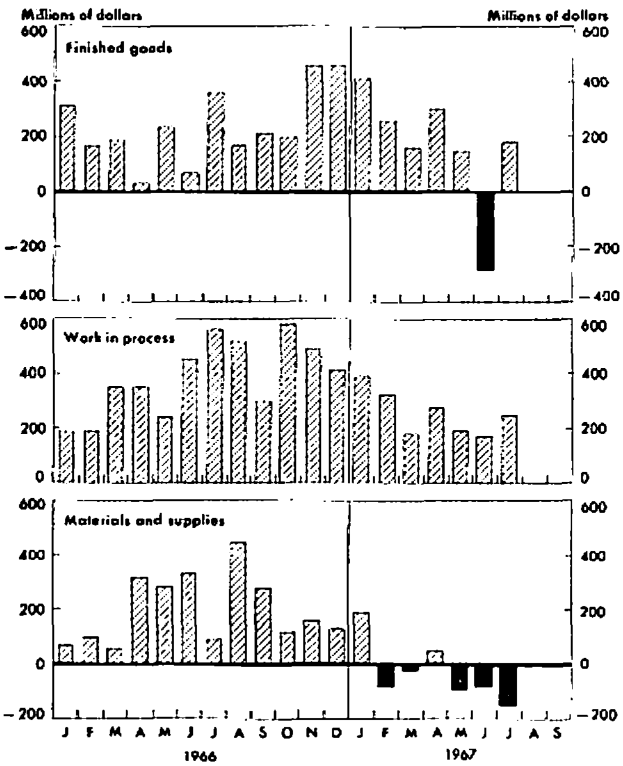
In the equipment category, defense-related production increased once again in a continuation of the rapid growth that began two years ago. The rise in the output of defense equipment over the first seven months of 1967 was at an annual rate of 18½ per cent, only moderately below the 22½ per cent increase registered over the full course of last year. At the same time, July saw this year's first increase in the production of business equipment. The slowdown in capital spending in the first half of 1967 had been reflected in a steady decline, dating from last December, in the pace of activity in the business equipment industries. The July rise in output of business equipment was not unexpected. Surveys of capital spending plans taken throughout this year, including the most recent one taken in August, have all pointed to increased outlays for plant and equipment in the second half.

The July rise in industrial production, while due in part to special factors, also provided some evidence that the inventory adjustment is nearing an end (see Chart I). This adjustment has, of course, been the major factor dampening industrial activity this year. Following the fourth quarter of 1966, when inventory additions averaged

Chart I

MANUFACTURERS' INVENTORY ACCUMULATION

Seasonally adjusted



Source: United States Department of Commerce.

about $1½ billion a month, the rate of business inventory accumulation declined sharply.[1] In June, manufacturers actually reduced their inventories, the first decumulation in three years. In the following month, however, such stocks rose once again. The July accumulation was centered in inventories of work in process, and finished goods. Inventories of raw materials and supplies were cut back further.

Although the overhang of excessive inventories at the beginning of the year was most noticeable in the manufacturing sector, trade inventories early in 1967 were also high relative to sales. As a result of rising sales and of inventory reductions during the first half, however, inventory-sales ratios in the trade sector by midyear had moved back down to levels prevailing before the inventory surge in the later months of 1966. Indeed, the trade sector accounted for almost half the December-June cutback in total inventory accumulation. The June inventory-sales ratio for retail trade was the lowest in many years.

The continued rise in the backlog of orders on the books of durables manufacturers is another element of strength in the outlook for production and employment. Though new orders for durables declined in July from the high June level, largely as a result of a sharp drop in the volatile defense component, the backlog of unfilled orders expanded once again. The July increase put the backlog at a new record, surpassing the previous high set last December. At the same time, shipments by durables manufacturers rose for the third month in a row.

Residential construction activity is apparently continuing its vigorous recovery from the depressed 1966 pace. In July, housing starts rose strongly to an annual rate of 1.35 million units, closely approaching the average level that prevailed before last year's slump. Although the number of units authorized by building permits eased off slightly in July, prospects for further improvement in residential construction continue to be favorable. Statistics on vacancy rates and sales of new homes indicate strong demand. At the same time, mortgage credit availability currently appears adequate for additional expansion in new home and apartment construction.

EMPLOYMENT, INCOME, AND CONSUMER DEMAND

Payroll employment rose sharply further in August. Most significant among the widespread gains was the upturn in manufacturing employment which resulted primarily from a large rise in the number of production workers employed. At the same time, the average week worked by manufacturing production workers increased again.

The civilian labor force expanded further in August for the third consecutive rise. In most of the earlier months of this year the labor force had declined on a seasonally adjusted basis, and the recent turnaround suggests that the quickening pace of economic activity has encouraged more individuals to enter the labor force. Reflecting the strength of demand in the labor markets, the growth of employment in both July and August exceeded the rise in the labor force, with the result that unemployment edged off to 3.9 per cent in July and 3.8 per cent in August.

[1] Revised figures for second-quarter gross national product (GNP) show a cutback in inventory accumulation larger than that previously estimated. However, upward revisions in other components—notably consumer spending—offset the reduced figure for inventory accumulation, and total GNP was therefore virtually unchanged from the preliminary estimate discussed in this *Review*, August 1967, pages 139-41.

Increases in personal income through most of the first half of 1967, though quite sizable, were nevertheless dampened by the sluggish behavior of employment during the period, and particularly by the reduction in the number of workers and the length of the workweek in manufacturing. In June and July, however, the expansion of personal income showed renewed strength as employment gains gave rise to rapid growth in wage and salary payments.

The stepped-up rate of income growth has undoubtedly been a factor in the recent strengthening of consumer demand. But, at the same time, consumers also seem to be showing a willingness to spend a larger share of their incomes. Indeed, recent revisions in the GNP accounts for the second quarter indicate that the advance in consumer spending was stronger than had been shown in the preliminary estimates. The revised figures put the second-quarter savings ratio at an estimated 6.7 per cent, down appreciably from the unusually high rate of 7.3 per cent in the first quarter. The second-quarter savings figure was nevertheless relatively high by historical standards, and it is altogether possible that future consumer spending may benefit from still further decreases in the savings ratio as well as from income gains.

In any case, the available data do indicate rising consumer demand. According to preliminary estimates, retail sales volume recorded a sizable increase in July, following a strong rise in the preceding month. During the first five months of the year, sales at retail stores had followed a generally upward course but at a very modest pace. Thus, in the five-month period ended with May, retail sales rose only 2 per cent; the June-July expansion, in contrast, amounted to fully 3 per cent. In July, the increase was centered entirely at durables outlets, where gains were reported both for the automotive group and for other hard goods lines. Sales of new automobiles in July were at a seasonally adjusted annual rate of almost 8½ million units, well above the low point of 7 million reached last February. In August, however, automobile sales dropped off, reportedly because of a short supply of cars in the popular lines. At the month end, the inventory of 1967 models was more than 25 per cent below carry-over in 1966 of prior-year models (the timing of the changeover to the new models was the same in both years).

WAGES, PRODUCTIVITY, AND PRICES

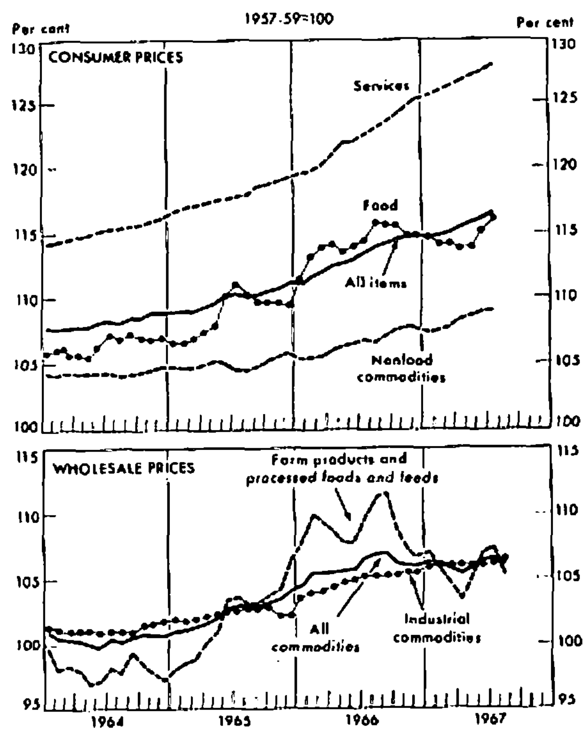
Wage costs continue to mount and the rate of increase has accelerated. According to the Bureau of Labor Statistics, collective bargaining settlements concluded in the first half of 1967 involved wage and fringe benefit increases totaling 4.6 per cent a year, compared with increases of 4.1 per cent for all of 1966 and 3.3 per cent for 1965. The rapid advance in labor compensation this year has been accompanied by a leveling off in productivity growth. The combination of rising labor costs and virtual stability in output per man-hour resulted in a sharp increase in labor costs per unit of output. To be sure, the index of unit labor costs in manufacturing fell a bit in July, as the result of a jump in productivity associated with the upturn in output. Nevertheless, the July level of the index represented an advance over the first seven months of this year at a seasonally adjusted annual rate of about 5½ per cent, compared with a rate of 3½ per cent for all of 1966. While productivity can reasonably be expected to move upward once again 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.

In conjunction with the strengthening of demand, the rising trend in unit labor costs has been a major

Chart II

CONSUMER AND WHOLESALE PRICES

1957-59=100



Note: Consumer prices are plotted through July; wholesale prices are plotted through August (preliminary).

Source: United States Bureau of Labor Statistics.

source of upward pressure on prices. The midsummer was marked by a rash of announced price increases for a broad range of commodities, including trucks, rubber goods, household appliances, textiles, construction materials, aluminum and steel for can-making, a variety of other steels, and goods containing silver. Moreover, railroad freight rates—which affect costs throughout the economy—were also raised.

Some of these increases have already had an effect on the broad index of industrial wholesale prices. Preliminary figures indicate that this index rose sharply in August after five months of stability (see Chart II). Wholesale prices of agricultural commodities, however, dropped in August after a steep three-month run-up, and this decline more than outweighed the increase in industrial commodities. As a result, the total wholesale index moved lower. In the consumer area, prices rose by a sharp 0.4 per cent in July as costs of food and services increased again. Prices of nonfood commodities also rose substantially. The overall advance was the largest in nine months and followed four months of sizable gains. From February to July, the total consumer price index advanced at an annual rate of 3.6 per cent, compared with 1.5 per cent in the preceding five-month period.