

The Business Situation

The economy has displayed considerable underlying strength in recent months, despite the adverse effects of a number of strikes. At the same time, the clearly excessive rate of increase in both wages and prices appears to be gaining further momentum. In October, the expansion of the economy equaled the longest on record, with the upswing covering eighty months.

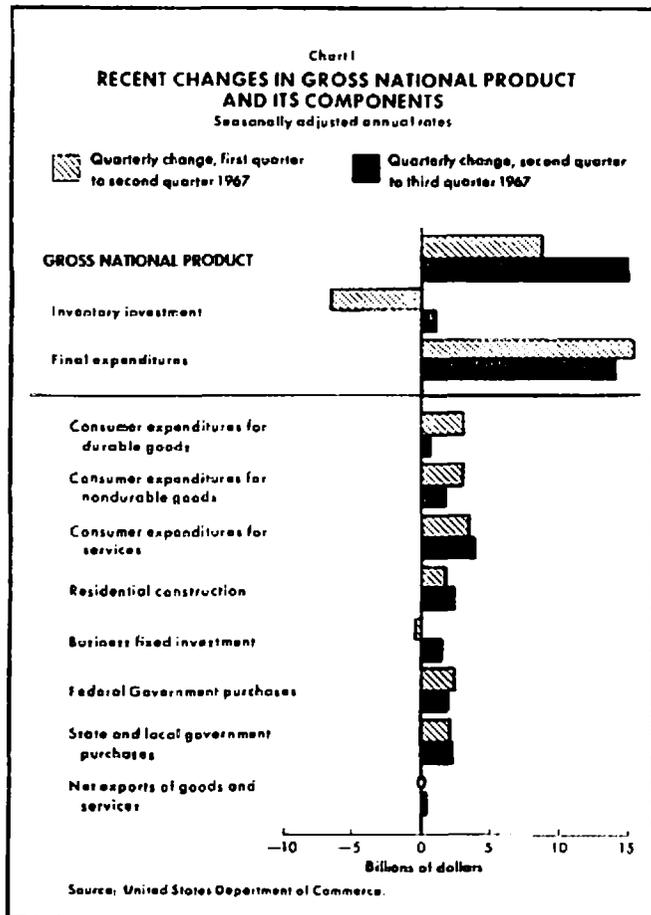
Gross national product (GNP) increased in the third quarter by an estimated \$15 billion. The gain in economic activity was widely based, with all major components of GNP registering advances. The increase in GNP was due about equally to higher prices and a larger real output. The rise in the GNP price deflator was nearly 4 per cent at an annual rate, the largest in many years. Real output in the economy increased at slightly more than a 4 per cent annual rate, up strongly from the rate of growth in the second quarter. This advance provides clear evidence of the rising pace of business activity since midyear.

In September, the effects of the various work stoppages, especially the auto strike, dampened the rise of personal income, employment, and retail sales and contributed to declines in industrial production and new orders for durable goods. The possibility of additional shutdowns in the automobile industry clouds the outlook for the economy in the remaining months of the year. Most observers nevertheless expect a continuation of the overall expansion, followed by a surge of activity when the automobile industry returns to full production. Although the President's tax surcharge proposal still awaits Congressional action and the ultimate outcome of efforts to reduce Federal spending remains unclear, economic and financial developments continue to indicate a pressing need for a program of fiscal restraint.

ECONOMIC ACTIVITY IN THE THIRD QUARTER

Gross national product—the measure of the nation's total output of goods and services—posted a sizable ad-

vance in the third quarter of 1967, when both price inflation and real output accelerated. According to preliminary estimates by the Department of Commerce, GNP increased by \$15.0 billion to an annual rate of \$790.1 billion (see Chart I). Although the gain was the largest since the first quarter of 1966, amounting to an annual growth rate of



8 per cent, it would have been even greater but for the effects of the various work stoppages. Indeed, according to a Commerce Department estimate, the Ford strike alone cut about \$2 billion from the quarter's GNP.

While price increases accounted for nearly half of the third-quarter gain in the market value of GNP, the growth in real output was nevertheless at a relatively strong annual rate of more than 4 per cent, compared with less than 2½ per cent in the second quarter and with a small decline in the first quarter of the year. The acceleration in the rate of increase in the overall price level, as measured by the GNP price deflator, was of disturbing proportions. The third quarter saw the deflator rise at an annual rate of 3.8 per cent, the largest advance in a decade and nearly twice the second quarter's 2.1 per cent rate of increase. To be sure, some of the third-quarter rise was due to a rash of price hikes in the construction industry and a steep run-up in food prices, and both these particular uptrends may moderate in coming months. However, the trend toward higher rates of increase in prices and costs remains apparent. Recent wage settlements—notably that at Ford which involved an increase of about 6 per cent annually in wages and fringe benefits—indicate a further escalation of wage costs, despite modest gains in productivity this year.

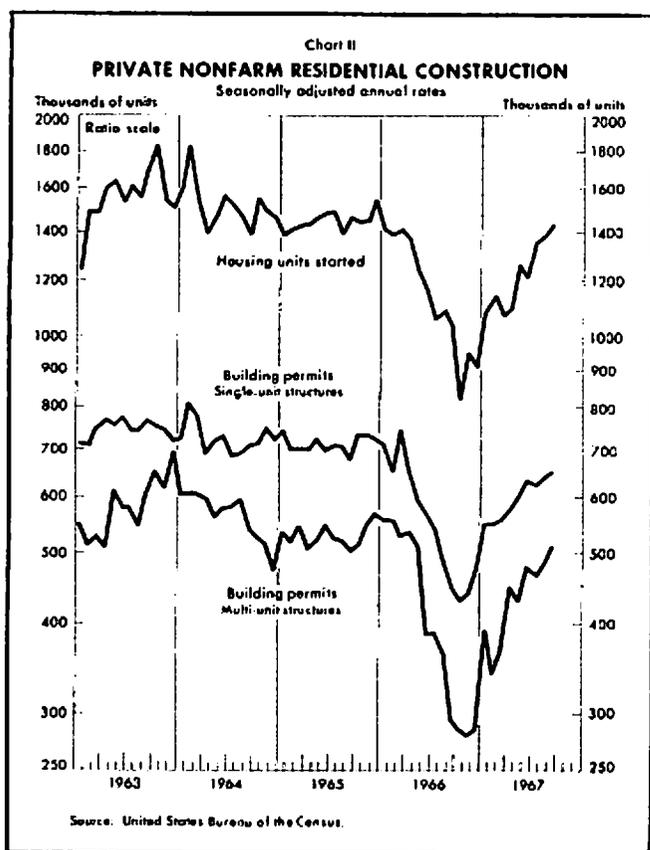
Further evidence of increasing inflationary pressure is seen in the September data on retail and wholesale prices. While the consumer price index rose only 0.2 percentage point in September, compared with a gain of 0.4 point in August, the advance in the index of all items less food was the largest this year. Prices of services mounted rapidly, as did those of used cars, apparel, and other goods. The wholesale price index also rose in September, as costs of industrial commodities increased for the second consecutive month following a half year of stability. Preliminary figures indicate that the industrial index rose again in October. Wholesale food prices appear to have declined further, however, outweighing the advance in the costs of industrial products, and the total wholesale price index apparently eased off 0.1 percentage point.

The third-quarter acceleration in the growth of GNP was due to a turnaround in the trend of inventory accumulation. During the first half of the year, when businessmen were concentrating on getting stocks into a better alignment with sales, the pace of inventory investment was sharply reduced, dropping from an excessively high \$18.5 billion annual rate in last year's fourth quarter to only \$0.5 billion in the second quarter of 1967. This slowdown put a very substantial drag on GNP growth during the first half. In contrast, the third quarter saw a pickup in inventory accumulation to an annual rate of \$1.5

billion, which contributed \$1.0 billion to the advance in GNP. The process of adjusting inventories to sales trends has brought inventory-sales ratios—especially in the trade sector—down to more acceptable levels. With the sales outlook improving, business accumulation of stocks can now be expected to proceed at a higher pace.

Consumer demand expanded only moderately during the third quarter, with consumption expenditures growing by \$6.1 billion as compared with the strong \$9.5 billion increase recorded in the preceding three-month period. Spending on services was up sharply, while growth of nondurables demand was slower than in the second quarter. The more moderate advance in consumer spending, however, was due mainly to a slowdown in automobile sales, which limited the rise in spending on durables. Consumer expenditures on durables moved up by only \$0.5 billion in the third quarter, compared with a gain of \$3.1 billion in the second quarter. Beginning in late July and continuing through most of September, car sales were hampered by shortages in several popular model lines. Sales of new domestically produced cars reached a 1967 peak in July at a seasonally adjusted annual rate of almost 8½ million units, and then dropped off in August to a rate of less than 7½ million units. The introduction of new models in late September improved the supply situation, and the sales rate moved up to a bit more than 8 million units. The precise effect on September auto sales of the strike at the Ford Motor Company is difficult to estimate. Although the company produced new cars in quantity before the strike began, many customers were apparently unaware that the new models were actually available and this fact may have discouraged potential buyers. By October, the supply of new-model automobiles, which Ford produced prior to the strike, began to run out and industry-wide sales declined to a rate of less than 7 million units.

The modest third-quarter advance in consumer spending occurred despite the strongest rise in personal income this year. The strength of the advance in income was particularly notable, since the increase in September was dampened considerably by the effect of the various strikes. The annual rate of wage and salary payments in that month grew by only \$0.9 billion, compared with gains of \$2.5 billion in July and \$3.3 billion in August. Inasmuch as disposable personal income advanced in the third quarter at a more rapid rate than consumption spending, the savings ratio moved up. Since the fourth quarter of 1966, consumers have been saving an unusually large share of their income. Uncertainty over a possible tax increase, inflation, and the Vietnam war has apparently held consumer spending down. The high savings rate of the last four quarters has resulted in a rapid expansion in the volume of financial



spending. These surveys have repeatedly pointed to an upturn in such outlays in the second half, following the drop in the first six months of the year.

Residential construction has continued to make a strong recovery from the steep decline experienced in 1966, and the \$2.3 billion advance in outlays during the third quarter was the largest in many years. The most recent data point to a continuation of the uptrend in home building, and the supply of mortgage funds currently appears to be sufficient for further growth. In September, housing starts rose sharply again, reaching the highest level since 1965, and building permits issued by local authorities also moved up further (see Chart II).

Turning to the public sector, the growth in the third quarter of total government expenditures for goods and services was the smallest quarterly increase in over two years. The \$2.2 billion rise in state and local spending was in line with the steady upward trend of such outlays. The advance in Federal Government expenditures slowed, however, as spending for defense purposes registered a \$1.4 billion rise, the smallest since the beginning of the buildup in Vietnam.

PRODUCTION, ORDERS, AND EMPLOYMENT

The volume of industrial output was dampened in September by the automobile strike, as well as by other work stoppages, and by the cutback of domestic crude oil production as shipments from the Middle East increased. The Federal Reserve Board's index of industrial production (seasonally adjusted) declined by 1.5 percentage points to 156.3 per cent of the 1957-59 average. Output of defense equipment continued to expand strongly, but production of business equipment was again about unchanged. The materials index was adversely affected not only by the reduction in oil production but also by the strike of steel truckers, which resulted in a widening number of cutbacks in steel production during September and October. Output of consumer goods was, of course, limited by the auto strike. The seasonally adjusted annual rate of new car assemblies dropped in September by almost 20 per cent to approximately 6¾ million units, a pace which was about maintained in October. Output of other consumer goods, however, was generally strong in September. Production of television sets rose again, following a surge in August which had been preceded by months of decline as a result of both production cutbacks and a strike.

The automobile strike also contributed to a large drop in the September volume of new orders for durable goods. In the motor vehicles and parts component—where new orders are treated as essentially equal to ship-

savings—particularly in the form of time and savings accounts at commercial banks and thrift institutions. This buildup in liquid assets, coupled with the outlook for further income gains, has placed the consumer in a strong position for a step-up in spending.

Recent surveys of consumer expectations have shown a substantial upturn in consumer buying intentions. Indeed, according to the latest survey taken by the Department of Commerce, consumers expect to spend a record amount for new cars in the coming months, and planned purchases of other durables have shown a strong rise.

Total fixed investment spending in the third quarter recorded the largest advance in over two years on the strength of increases in both business fixed investment and residential construction. The rise in business spending was centered in purchases of equipment. Outlays for business structures also edged up, however, marking the first increase in a year. The growth of business capital spending in the third quarter was consistent with the trend indicated by earlier surveys of business plans for plant and equipment

ments—the decline amounted to over 25 per cent. On the other hand, the volatile series on new orders received by defense-oriented industries rose sharply after falling for two months. The auto strike was also a factor in the decline in shipments of durable goods. The volume of shipments was less than the inflow of new orders, and thus the backlog of unfilled orders edged up.

The labor market situation remained strong in September, although the picture provided by the employment data was clouded by the effects of the various strikes—notably those involving teachers in New York City and elsewhere and the workers at Ford. The number of persons on strike increased by more than 200,000 between August and September. Despite this, the total number of persons on the payrolls of nonagricultural establishments declined by only 100,000. The Bureau of Labor Statistics estimates that, had it not been for the rise in the number of workers involved in labor disputes, September payroll employment would have shown a gain of better than 100,000. The

BLS noted that the Ford strike did not have much secondary effect on September employment. However, the prolongation of that stoppage through most of October undoubtedly increased the strike's indirect impact, which may be reflected in October data. The average workweek of production workers in manufacturing held in September at the much improved figure of 40.7 hours reached in the preceding month.

The civilian labor force expanded in September for the fourth consecutive month. The September advance was entirely accounted for by an unusually large rise in the number of women in the labor force. Not all these additional women found employment, and the unemployment rate for them rose substantially, pushing the overall rate up by 0.3 percentage point to 4.1 per cent. The unemployment rates for men and for teen-agers were essentially unchanged, but the rate for married men, who represent the backbone of the labor force, declined to 1.8 per cent, close to its record low.