The Business Situation

The first three months of 1968 saw a record—and clearly excessive—advance in the dollar value of outlays for goods and services in the United States. Substantial further increases in market prices were partly responsible, but even after adjustment for price changes total output advanced almost 6 per cent at an annual rate, much above the 4 per cent or less that is considered sustainable at full employment. Buoyant consumer demand was the major factor in the overall gain, but most other spending categories also increased. The pronounced caution that consumers had exhibited throughout 1967 appears to be diminishing, as evidenced by a marked drop in the personal savings rate from 7.5 per cent of income in the final quarter of last year to 6.8 per cent.

Against this background of rapidly expanding aggregate demand, prices—already under heavy pressure from rising wages and other costs—continued their sharp advance. The gross national product (GNP) deflator, which is the broadest measure of price trends in the economy, rose at a 4 per cent annual rate in the first quarter of 1968, going beyond the already excessive increases of the previous two quarters. The size, persistence, and widespread nature of these price advances raise the threat of a major inflationary spiral unless fiscal measures are undertaken to reduce substantially the economic stimulus now being provided by a huge Federal deficit.

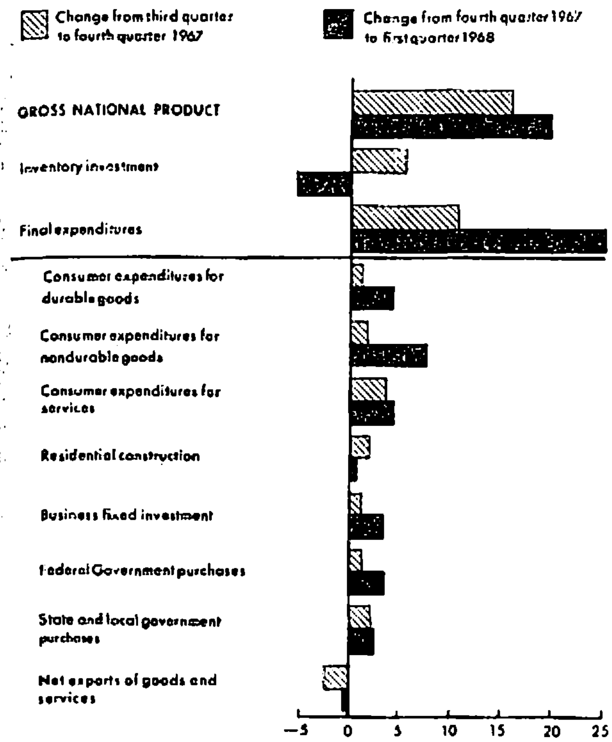
GROSS NATIONAL PRODUCT IN THE FIRST QUARTER

According to preliminary estimates, GNP rose in the first three months of the year by a record-breaking $20.0 billion (see Chart I) to a seasonally adjusted annual rate of $827.3 billion. This economic expansion, which amounted to 9.9 per cent at an annual rate, included a 5.9 per cent increase in physical output and a 4.0 per cent jump in average prices. The gain in real output was the highest since early 1966, and the price inflation was the sharpest in more than a decade.

Consumer spending was a major factor in the steep rise of GNP during the first quarter. Such spending swelled by a record $16.0 billion, compared with an average quarterly rise of only $7.0 billion during all of 1967. The increase was due both to a rapid advance in disposable income and to consumers' willingness to spend a greater portion of their income. Disposable incomes rose by a near-record $13.8 billion, helped in part by the February increase in the minimum wage and the March rise in social security benefits. At the same time, the savings rate, which had been running at an unusually high level since the end of 1966, dropped from 7.5 per cent of disposable income in the fourth quarter to 6.8 per cent. Taken by itself, the decline in the savings rate accounted for about $3.8 billion of the $16.0 billion increase in consumer spending. Consumer demand ended the first quarter on a strong note. Following sizable gains in retail sales in both January and February, preliminary figures indicate that sales in March posted another large advance, rising by $0.5 billion to $28.0 billion. Further, recent surveys of consumer spending plans tend to support the view that consumer optimism and buying interest are on the upswing.

Roughly half of the first-quarter advance in consumer spending was in the nondurables component, where price increases—notably for food and apparel—were substantial. In the durables sector, spending was boosted by a rapid advance in sales of furniture and new cars. Furniture sales were sluggish throughout 1967 because of reduced home purchase and rental, stemming from the previous year's slump in residential construction. With the recovery in the housing sector, an improvement in furniture sales was not surprising. Sales of domestically produced cars increased to a seasonally adjusted annual rate of 8.2 million in the January-March period, up 10.2 per cent from the strike-reduced pace of 7.4 million units in the fourth quarter. At the same time, there was a strong upsurge in imports of foreign cars. While domestic sales of foreign-built cars have been rising in the last five years, the trend accelerated markedly in recent months, perhaps owing in some degree to the price increases on domestically produced cars. During 1967, imports claimed over 9 per cent of the United States market—within striking distance of the 1959 high of 10.2 per cent. In the first quarter of this year, moreover,

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



Source: United States Department of Commerce.

sales of foreign-built cars ran at a seasonally adjusted annual rate of 1 million units—up over 40 per cent from the first three months of last year.

The first-quarter surge in consumer spending apparently cut heavily into the buildup of business inventories, especially at the retail and wholesale level. Due partly to this factor, inventory spending by all business declined to a $3.9 billion annual rate during the quarter, down $5.3 billion from the preceding quarter. But, while accumulation in the trade sector lessened, manufacturers added to their total inventories at a relatively strong pace during the quarter, in part because of the buildup in steel and auto stocks.

Both business fixed investment outlays and residential construction spending increased during the quarter. The $3.2 billion advance in business fixed investment was the largest since the final quarter of 1965 and confirmed survey expectations of an upturn in the growth of capital spending this year. Moreover, the most recent survey of plant and equipment spending plans, taken by McGraw-Hill, Inc., in March, indicates that businesses have revised their 1968 capital spending plans upward to a level 8 per cent above that spent last year. The sizable fourth-quarter increase in corporate profits—the first substantial advance since the fourth quarter of 1965—had strengthened the outlook for plant and equipment spending, and early indications are that corporate profits expanded still further in the first quarter of 1968. In the housing sector, spending rose to a record $28.3 billion annual rate, up $0.7 billion from the final quarter of last year. Data on recent housing starts, building permits, and contract awards for residential construction suggest that spending should continue at a high rate in the next few months. Despite some tightening of the home mortgage market, both housing starts and permits were little changed in March from the high February pace and new residential construction contract awards jumped 9 per cent over the February level. Moreover, the low vacancy rates in existing structures continue to indicate a strong potential demand for new homes.

In the public sector, total Federal and state and local government purchases of goods and services climbed by $5.8 billion in the first quarter—the largest increase in a year. The rise was chiefly due to a $2.4 billion gain in defense spending and a $2.4 billion rise in expenditures by state and local governments. The defense increase followed two quarters of small advances, whereas state and local spending was in line with the strong and steady upward trend in that sector.

The strong pull of aggregate demand and the strike by New York longshoremen in March further weakened the trade surplus in the first quarter, and net exports declined again. While exports advanced during the quarter, rising purchases of foreign-produced steel, copper, automobiles, machinery, and civilian aircraft parts contributed to a more than offsetting increase in total imports. Based on data for January and February alone, the Commerce Department had estimated that net exports in the first quarter declined to an annual rate of $2.6 billion, the lowest since the first quarter of 1960. Moreover, this figure is expected to be revised lower when the March results are incorporated. In March, when the Port of New York was struck for eleven days, the merchandise trade balance, as recently reported by the Census Bureau, actually registered a small deficit, the first time this has occurred in five years.

RECENT DEVELOPMENTS IN PRODUCTION AND EMPLOYMENT

The Federal Reserve Board's index of industrial production advanced for the second consecutive month in March. Output rose 0.6 percentage point to a record 162.1

per cent of the 1957-59 average. Gains were widespread, but were centered in the automotive and steel components. Production of motor vehicles and parts jumped 5½ per cent in March, following two months in which output had been adversely affected by local labor disputes. Passenger car production climbed by over 9 per cent to a seasonally adjusted annual rate of 8.9 million units. In April, however, the civil disorders following the assassination of Dr. Martin Luther King, Jr., curtailed production early in the month, and initial indications are that output fell 3½ per cent to a rate of 8½ million units. Iron and steel production rose again in March, as buyers continued to hedge against a possible steel strike this summer. According to preliminary figures, steel output in April gained fully 6 per cent over the March level, reaching an all-time record of 12.7 million tons at a seasonally adjusted monthly rate. Production increases in most other industries were small in March, but coal output jumped by 10 per cent from the strike-reduced pace of January and February.

The near-term outlook for production was bolstered somewhat by the rise in new orders received in March by manufacturers of durable goods. On the strength of a big increase in orders for civilian aircraft, new orders rose $1.3 billion to $26.1 billion. Among other durables manufacturers, the flow of new orders generally continued at a high rate. Shipments by durables manufacturers rose $0.5 billion in March to $25.2 billion, and because the advance in shipments was less than the rise in orders, the backlog of unfilled durables orders rose for the second month, reaching a new record of $80.3 billion.

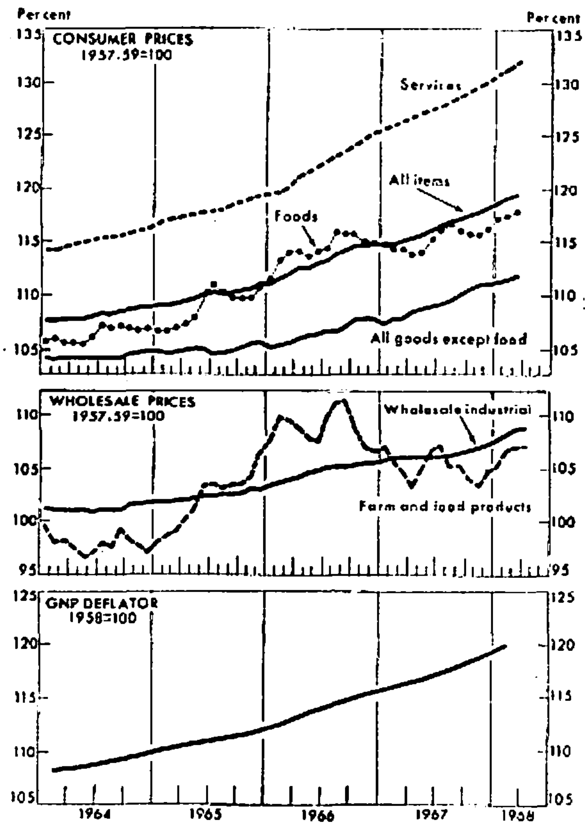
Recent increases in manufacturing production, although substantial, have trailed overall GNP growth. Moreover, manufacturers in general still report some excess plant capacity. Plant and equipment spending has continued at a high level, and new production facilities are being brought on line at a fast clip. These additions to plant capacity, coupled with the weakness in production during 1967, brought about a substantial decrease in capacity utilization rates. Although manufacturing production rose at an annual rate of about 5 per cent in the first quarter, the growth in capacity is estimated to have outstripped this increase, and the overall capacity utilization rate edged off by 0.3 percentage point to 84.1 per cent. (The preferred operating rate in manufacturing is usually judged to be around 90 per cent.)

In contrast to current utilization rates, developments in the labor market continue to highlight the fact that labor is now a critical factor limiting further expansion of real output. Following a large February increase, nonagricultural employment rose in March by 143,000 to a level of almost 68 million. Gains were centered in public and private services and in the trade sector. Advances in some manufacturing categories were offset by additional layoffs due to the glassblowers' strike. The civilian labor force eased slightly during the month, but the increase in employment resulted in a 0.1 percentage point decline in the overall unemployment rate to 3.6 per cent. Although teenage unemployment rose, the unemployment rates for both adult men and adult women fell. At 2.2 per cent of the labor force, adult male unemployment was equal to the lowest rate since 1953.

PRICES AND COSTS

The price situation deteriorated further in the first three months of the year (see Chart II.) A steep escalation in wage costs in a tight labor market and rapidly rising

Chart II
PRICES



Note: The GNP deflator is plotted on a quarterly basis. All other data are monthly. Wholesale prices for April are preliminary.

Sources: United States Department of Labor and Department of Commerce.

prices at the wholesale and retail levels have become major threats to the orderly growth of the economy. During the 1961-65 phase of the expansion, prices and costs rose on average at a fraction of the recent rates of increase. The GNP deflator moved up at an average annual rate of 1.5 per cent in those five years. Industrial wholesale prices averaged annual increases of 0.4 per cent, and consumer prices—reflecting mounting service as well as other costs—advanced at an average yearly rate of 1.4 per cent. At the same time, labor costs per unit of output actually declined by an average of 0.3 per cent per year, as productivity grew faster than wages. The overheating of the economy in 1966 changed all this, however. Prices in that year moved up sharply in response to excess demand, while depressed agricultural production accentuated the rise in food prices. Then in 1967 cost pressures, inherited partly from the demand-pull inflation in 1966, pushed prices up on all fronts, particularly in the last half of the year when demand conditions began to improve. Thus, the GNP deflator rose 3.0 per cent in that year even though demand pressures were generally moderate. Industrial wholesale prices turned up sharply last summer, after virtual stability in the first half of the year, and increased 1.8 per cent over 1967 as a whole. In manufacturing, unit labor costs—reflecting strong competition in the labor markets, increasingly large negotiated wage settlements, and slow productivity growth—climbed 4.0 per cent last year, and consumer prices rose 3.1 per cent.

In the first three months of this year, price advances continued to accelerate. The GNP deflator increased at an annual rate of 4.0 per cent, and by the end of the quarter industrial prices had soared at an annual rate of 4.5 per cent over the December level, although preliminary figures suggest that this upward trend moderated a bit in April. Wage costs increased even more than other price trends. Higher wage rates and other labor costs, such as the increased social security contribution required of employers, combined with lagging productivity gains to push labor costs per unit of output up at an annual rate of fully 10.1 per cent in the first three months of the year. Reflecting this broad upward movement, consumer prices advanced at an annual rate of 4.4 per cent in the quarter, and in March the index rose at a yearly rate of 5.0 per cent. Against this background of rising wage costs, a tight labor supply, and the recent increases in industrial wholesale prices, the first-quarter surge in consumer demand adds further to the likelihood that consumer prices will rise sharply in the coming months.