The Business Situation

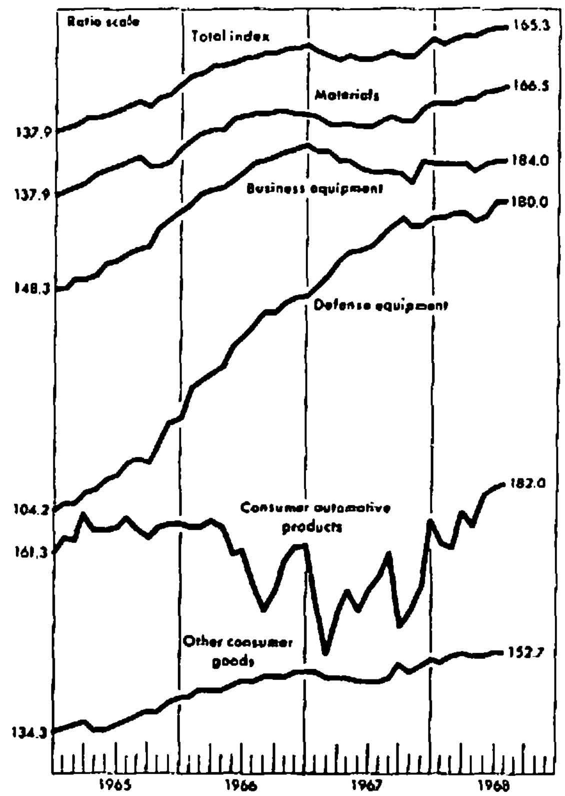
Domestic economic activity continued strong through midsummer. In July, industrial output expanded somewhat further, housing starts recovered sharply, and conditions in the labor market remained firm. Retail sales apparently registered a sizable gain and, according to the latest survey, consumers plan continued heavy spending in the months ahead. Another recent Government survey indicates that businessmen have reduced their 1968 plant and equipment spending plans since the last survey was taken in May, but outlays in the second half of the year are still expected to exceed the total for the first six months. Despite the recent strong showing of most business statistics, some much needed moderation in the economy is expected in future months as fiscal restraint takes hold.

PRODUCTION, INVENTORIES, AND CONSTRUCTION

The total physical volume of industrial output continued to advance in July. The Federal Reserve Board's production index rose 0.6 percentage point to a seasonally adjusted 165.3 per cent of the 1957-59 average (see Chart I). The gain in the overall index was attributable in large part to a further surge of activity in the steel industry prior to the July 31 labor contract expiration, but the estimated production of the mining industries—which include oil and gas extraction—also showed a marked increase. Output in manufacturing sectors other than steel showed little change on balance. The production index for motor vehicles and parts was essentially flat, although the rate of new car assemblies was up slightly. The auto industry scheduled yet another month of high production in August, as manufacturers worked to build inventories of new models in anticipation of their introduction in September.

In the steel industry, on the other hand, August was marked by a severe cutback in activity. On the basis of preliminary data, it appears that output declined by some 25 per cent—a development which was, of course, to be expected in the wake of the industry's labor contract settlement. Steel users had accumulated large inventories as a hedge against a possible strike, and production is expected to run at sharply reduced rates for some months as these

Chart I
INDUSTRIAL PRODUCTION
Seasonally adjusted; 1957-59=100



Note: Indexes for defense equipment and nonautomotive consumer goods were calculated at the Federal Reserve Bank of New York from data published by the Board of Governors of the Federal Reserve System. Indexes are not plotted in rank order.

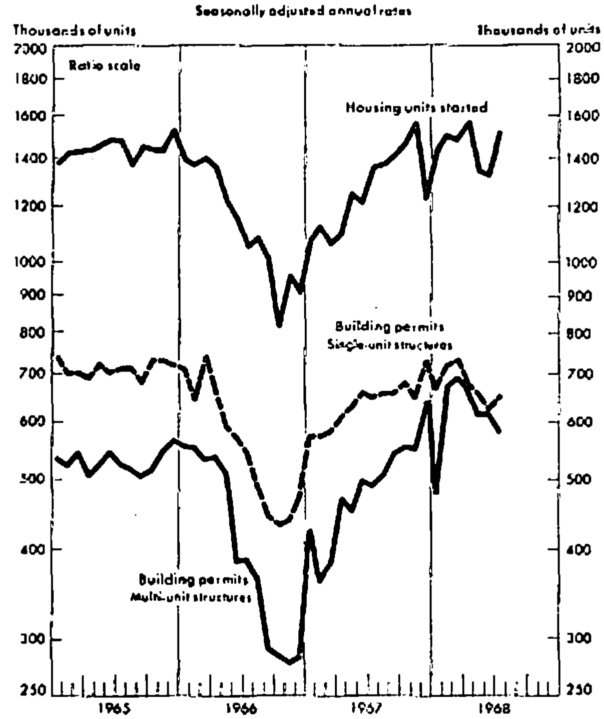
Source: Board of Governors of the Federal Reserve System.

inventories are worked down. Indeed, some industry analysts see domestic steel shipments reduced by as much as 50 per cent in the second half of 1968, with the possibility of a substantial inventory carry-over into 1969 even at the reduced shipments pace. On the other hand, the overall inventory situation in manufacturing appears quite good. Total inventories of all manufacturers rose only moderately in July, following similarly modest increases in the previous two months. Coupled with a strong rise in shipments, this resulted in a decline in the ratio of inventories to shipments in manufacturing to 1.67 in July, the lowest level in two years.

The volume of new orders received by durables manufacturers edged up slightly in July to a seasonally adjusted \$24.7 billion. Virtually the entire gain was due to a very sharp advance in the bookings reported by the aerospace industry. In other, less volatile sectors of durables manufacturing, the flow of new orders was either unchanged or somewhat lower in July. As expected, primary metals orders, which are dominated by steel, declined further in July, although the month's 6 per cent reduction was more moderate than the 11 per cent drop reported in June. Primary metals orders in July were back to the average monthly level prevailing in 1967 before the strike-hedge buying of steel began. Total shipments of durable goods, bolstered by the steel industry's efforts to move products out of the mills before a possible strike, advanced \$800 million to a record seasonally adjusted volume of \$26.2 billion. Since shipments exceeded new orders, the backlog of unfilled orders fell by \$1.5 billion to \$78.7 billion, the lowest level since late 1967.

According to the survey conducted in August by the Department of Commerce and the Securities and Exchange Commission, second-quarter business spending on new plant and equipment was at a seasonally adjusted annual rate of \$62.8 billion. The second-quarter outlay rate equaled that of last year's fourth quarter but was about \$2 billion below the strong first-quarter pace and, moreover, was about \$2 billion less than businessmen had anticipated spending at the time of the May Commerce-SEC survey. On the other hand, the business equipment component of the Federal Reserve industrial production index has been virtually stable since November 1967, and shipments reported by machinery manufacturers have followed a nearly identical pattern. Moreover, new orders for machinery and equipment were strengthened through the spring months, suggesting a pickup in capital spending later this year. The likelihood of such a pickup is supported by the findings of the latest Commerce-SEC survey. Although the survey found that businessmen have made a downward revision since May in their estimate of spending volume in the second half, their plans nevertheless indicate that total outlays in the period will be some 2 per cent larger than in the first six months of the year.

Chart II
PRIVATE NONFARM RESIDENTIAL CONSTRUCTION
Seasonally adjusted annual rates



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

The strong showing of corporate profits in the second quarter of this year is a plus factor in the outlook for capital spending. Corporate profits were at a \$50.3 billion seasonally adjusted annual rate in the second quarter, \$1.2 billion higher than in the first quarter and back to the level recorded in the fourth quarter of 1967. The 10 per cent surcharge on corporate income taxes was reflected in the profits figures for both quarters, as estimated by the Department of Commerce, since the surcharge is retroactive to January 1.

Private nonfarm housing starts surged upward in July by nearly 14 per cent on a seasonally adjusted basis to an annual rate of 1.52 million units (see Chart II). The monthly series on housing starts is highly volatile, however, and while estimated starts jumped sharply in July there was a slight decline in the much less erratic monthly series on the number of housing units authorized by building permits. A continued expansion of housing construction can be expected under current financial conditions, but it may be several months before this is fully reflected in the building statistics.

INCOME, CONSUMER DEMAND, AND EMPLOYMENT

Personal income, measured at a seasonally adjusted annual rate, expanded in July by a sizable $5.5 billion, matching the increases in the two preceding months. The dominant factor in the gain, however, was a jump in the earnings of Federal Government employees, whose July paychecks reflected the second step of a three-stage pay raise legislated late last year. The first step became effective in December 1967, and the third increase will occur in July 1969. The Department of Commerce has estimated that the July pay raise accounted for $1.5 billion of the total July increase in personal income. In marked contrast, the growth of private wages and salaries slowed sharply in July to only $1.5 billion, compared with a large $4.0 billion gain in June. The slowdown was concentrated in the "distributive" industries—retail and wholesale trade, transportation, communications, and utilities. Manufacturers' payrolls were up in July, although by slightly less than the average monthly increase registered in the first half of 1968.

Retail sales jumped by 3 per cent to a record volume in July, according to the preliminary estimate for the month. While the increase in personal income tax withholding that took effect at midmonth was not generally expected to have an immediate, sharp impact on sales at retail outlets, most observers were nevertheless rather surprised at the strength of the month's advance—especially in view of the essentially flat second-quarter performance. Of course, preliminary estimates of retail sales must be treated with caution, since they are often substantially revised. The reported July advance was led by a 5 per cent spurt in durables purchases, paced by heavy auto sales, but volume at nondurables outlets also rose strongly. July sales of new domestically produced cars were at a very high 9.1 million unit seasonally adjusted annual rate.

The July Department of Commerce survey of consumer buying intentions does not provide an unambiguous indication of the effects of the fiscal restraint package on consumer demand in the months ahead. The survey was taken in the first three days of July—after the 10 per cent income tax surcharge was passed by the Congress but before increased withholding became effective on July 13. It is not clear to what degree consumers took the effects of reduced paychecks into account when reporting their purchasing plans for the next six months. In general, the survey reported no significant changes—either up or down—in the strong spending patterns observed since the fall of 1967. In particular, planned spending on new cars was higher in July than in April, with the demand for used cars off somewhat. The index of intended expenditures for the purpose of buying houses had been increasing sharply since last fall, and the July survey found another large increase in planned home purchases. Planned expenditures on household durables remained virtually unchanged at roughly the same level which has held for the last eighteen months.

The civilian labor force, having reached a record high in June at just over 79 million persons (seasonally adjusted), declined very slightly in July. The overall unemployment rate was essentially unchanged. As published by the Bureau of Labor Statistics, the rate edged down by 0.1 percentage point to 3.7 per cent. The 0.3 point June rise in the rate had been mainly attributable to an unusually large influx of youthful workers, who had difficulty finding jobs. The July data suggest that the unemployment situation of most labor force groups was about unchanged from June, and the teen-age unemployment rate remained at a quite high 13.6 per cent. On balance, the situation in July appears to have been one of stable, but relatively tight, labor market conditions.

The number of jobs in nonfarm establishments increased in July by a fairly moderate 159,000, with the gains spread evenly throughout the economy. Employment in manufacturing was bolstered by the fact that auto production remained high until much closer to the model changeover than is usually the case. Construction industry employment was also strengthened by a special factor—the return of workers who had been on strike in June. The average workweek of manufacturing production workers remained at the rather high level of 40.9 hours for the third consecutive month.

PRICE AND COST DEVELOPMENTS

The consumer price index continued its rapid climb in July, increasing at a 6 per cent annual rate for the second consecutive month. Nearly all components of the index contributed to the gain, but food and services prices in particular boosted the overall index. Food prices advanced at a 9 per cent annual rate after moving about in line with the overall index for several months. Services prices also rose at a 9 per cent annual rate, pushed up mainly by substantial increases in medical care and housing costs.

The wholesale price index fell in August by an amount exactly offsetting the July 0.4 percentage point increase, according to preliminary Bureau of Labor Statistics estimates. The decline centered in farm products and processed foods and feeds. The average price of industrial commodities remained at the June level, continuing the relatively stable pattern of the last few months.

The labor contract settlement in the steel industry at the end of July represented the completion of a "round" of major contract negotiations over the past year or so. Now that this round is completed, several factors affecting trends in labor costs per unit of output have become more clearly visible. The steel settlement called for wage and fringe benefit increases averaging roughly 6 per cent over the three-year life of the contract and was about in line with the pattern set in the October 1967 agreement at the Ford Motor Company and followed by other major industries since that time. While the contracts coming up for renewal in the remainder of this year and through 1969 cover sizable numbers of workers (notably in the aerospace, communications, and apparel industries), the industries involved are not generally considered to be pacesetters in the matter of contract settlements. Therefore, recent major wage settlements may provide some indication of what can be expected for the next several quarters. In general, recent contracts have called for very large first-year increases in wage rates, apparently reflecting the workers' desire to recover purchasing power lost in the rise of consumer prices over the past two years or so. The contracts have, for the most part, provided for smaller rates of wage increase after the first year. They have also stressed improvements in fringe benefits, but the labor-cost increases associated with such improvements are often scheduled to come in the later part of the contract period. In sharp contrast to the pattern of labor agreements in earlier inflationary periods, there has been little interest in cost-of-living escalator clauses. It is possible, therefore, that labor-cost pressures may ease—

assuming at least some reduction of demand pressures —once the 1968 surge in wage costs is over.