The Business Situation

Economic activity continued to expand as the third quarter ended. The August statistics gave some evidence of a slowing, primarily as a result of reduced production, orders, and shipments in the steel industry, as steel users began to work down their large strike-hedge inventories accumulated earlier in the year. The sharp drop of steel demand during August was reflected in a decline in industrial production. Output in other industries continued at a high level, however, in part due to a large buildup of manufacturers' inventories other than steel. Moreover, most other indicators of business activity remained strong. Retail sales, spurred by steadily increasing personal income and by a reduction in the savings rate, moved substantially higher in July and apparently remained at a high level over the balance of the summer. Record increases in consumer credit have made it possible, at least temporarily, for consumers to absorb the tax surcharge and still increase their retail purchases. At the same time, leading indicators of residential construction are considerably stronger than most observers had expected. With significant effects of the recently enacted fiscal restraint program yet to be felt, inflationary pressures have remained, and the rise in prices has continued little changed from earlier months.

PRODUCTION, INVENTORIES, AND CONSTRUCTION

Industrial output fell sharply in August, largely as a result of rapidly declining steel production. The Federal Reserve Board's index of industrial production dropped 1.6 percentage points to 164.0 per cent of the 1957-59 average. Aside from steel, output in most industrial sectors changed only marginally from very high July levels. Indeed, the overall production index excluding iron and steel rose by a modest 0.3 percentage point. Production of automobiles as well as other consumer goods declined slightly, with offsetting gains recorded in the output of both business and defense equipment.

The August decline in iron and steel production—which amounted to roughly 23 per cent—was severe. After both the 1962 and 1965 contract settlements, it took about four months for output to decline by comparable magnitudes. Steel production fell again in September but apparently by less than half the August drop. Judging from the depleted order books, the industry's operations will remain at a depressed level for several months. An important factor inhibiting recovery in the domestic steel industry is the heavy volume of orders for foreign steel which were placed in anticipation of a strike.

Manufacturers' inventories surged by $1 billion in August to a seasonally adjusted level of $86.9 billion, recording the largest monthly increase of 1968. The gains were spread fairly evenly through most manufacturing sectors, led by the primary and fabricated metals, transportation, food, and textile industries. On the other hand, manufacturers' shipments fell $1.7 billion to a seasonally adjusted annual rate of $49.4 billion. Nearly 70 per cent of the decline was accounted for by reduced shipments from steel mills, with only marginal changes in other industries. As a result of the opposite movements in the two series, the ratio of inventories to shipments in manufacturing increased from 1.68 in July to 1.76 in August, an unusually large one-month rise.

New orders received by durable goods manufacturers rose in August by $200 million to a seasonally adjusted $26.8 billion. The entire gain was accounted for by sharply higher orders to the producers of transportation equipment, especially aircraft and shipbuilding companies. The orders flow in other durable goods industries was generally off a bit. The primary metals industries showed the largest decline, reflecting the depressed state of the steel industry. Orders for machinery were down about 3½ per cent, although they remained quite high relative to earlier this year.

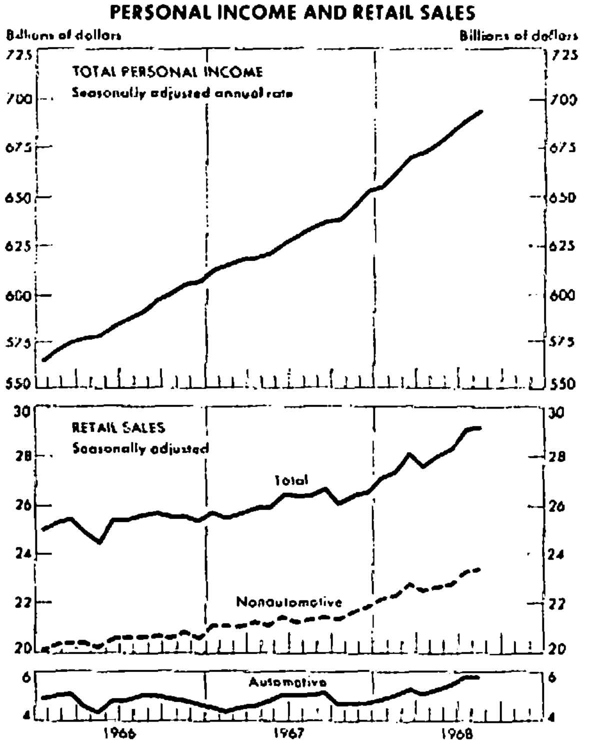
Private housing starts edged down in August by about 1½ per cent, but remained at a strong seasonally adjusted annual rate of 1.51 million units. The fact that housing starts changed so little from the high July level suggests that the sharp surge in that month was not due to temporary factors. The number of housing units authorized by new building permits also declined slightly in August. Though the number of permit authorizations has been edging down in recent months, a new data series recently published by the Department of Commerce indicates that there is a very sizable backlog of unused permits.

The drop in housing starts back in May and June prompted a wave of pessimism about the near-term outlook for residential construction. By the same token, the July and August recovery has given rise to a fresh wave of optimism. In view of the well-known volatility of housing starts, such sharp swings in expectations are clearly unwarranted on the basis of starts behavior over a very short time span.

INCOME, CONSUMER DEMAND, AND EMPLOYMENT

Personal income rose by $5.1 billion in August to a seasonally adjusted annual rate of $694.3 billion (see Chart I). Although slightly less than the $5.5 billion gain registered in each of the three preceding months, the August increase was right in line with the average gains of the last fifteen months. In July, wage and salary income was pushed up by the pay raise for Federal Government employees. The August increase was primarily due to larger payrolls in the nondurables manufacturing and service industries. Other sources of personal income—such as dividends, interest, and transfer payments—rose in August by amounts generally in line with those recorded in the last few months.

Chart I
PERSONAL INCOME AND RETAIL SALES



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

Although personal income has continued to grow strongly, the income tax surcharge that became effective in July has of course had the effect of cutting back disposable income. In response to this, consumers have the option of cutting back on consumption or alternatively on savings, which has been accounting for an unusually high share of income during the past year or more. It will be some time before the consumer's reaction to the surtax is clearly established, but so far consumer spending has been remarkably strong. Retail sales edged up by a further 0.3 per cent in August, according to preliminary estimates, following an unexpectedly large July surge. The total dollar volume of durable goods sales was unchanged, while purchases at nondurables outlets were up by 0.4 per cent. Sales of new domestically produced cars fell about 5½ per cent in August to a seasonally adjusted 8.6 million unit sales rate.

Total consumer credit outstanding expanded by a record $880 million in July and by an extraordinarily large $1.12 billion in August. The July increase was based on a continued heavy demand for durable goods, particularly automobiles, but also included a sharp upturn in the expansion of noninstalment credit. The August increase was unusual in that all categories of consumer credit expanded at extremely high rates. Since August retail sales increased only fractionally from the high July levels, it would appear that the proportion of consumer purchases made on credit was larger than in preceding months.

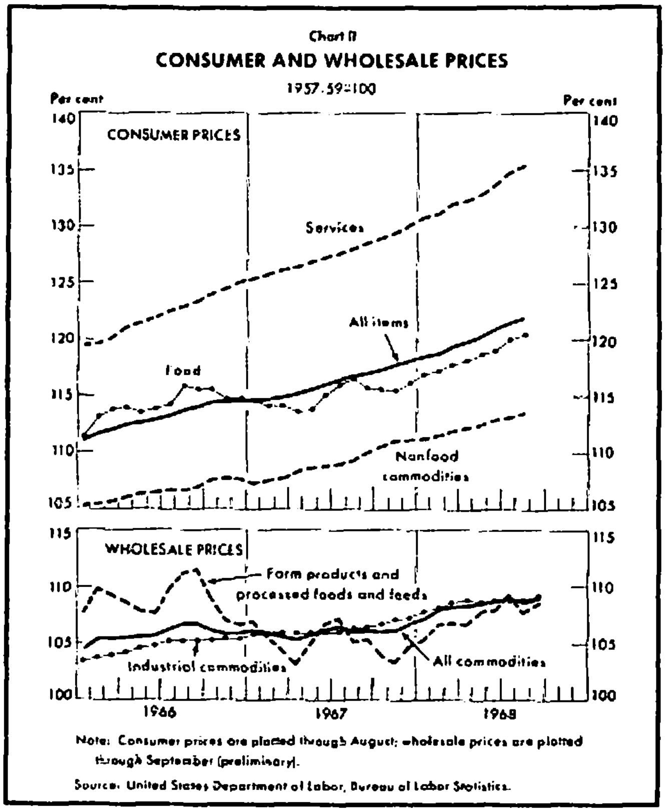
Some consumer credit market analysts think that conditions favor a continued rapid expansion of credit: consumers are quite solvent—outstanding debts appear to be low relative to financial assets—and they are devoting a somewhat smaller share of disposable income to instalment repayments than they did in the period of rapid credit expansion in 1965-66. Whether or not consumers continue to avail themselves of this borrowing capacity will have an important bearing on the strength of consumer demand in the months ahead.

The civilian labor force declined in August by about 300,000 persons, as sizable numbers of women and teenagers left the labor force. The unemployment rates for these two groups dropped, returning to the levels which had prevailed last spring. Consequently, the overall unemployment rate fell from 3.7 per cent to 3.5 per cent, marking the fourth month this year in which that very low rate has been registered. The jobless rate for adult men remained at the very low level of 2.2 per cent. The number of jobs in nonfarm establishments rose by just over 200,000 in the month, led by increased employment in the trade, services, and government sectors.

PRICE AND COST DEVELOPMENTS

The consumer price index rose in August at a 4 per cent annual rate to 121.9 per cent of the 1957-59 base (see Chart II). The price gains were widespread, affecting virtually all commodity and service groups. Housing costs rose at a 6 per cent annual rate, pushed up mainly by higher mortgage interest charges. Prices of food and apparel also increased more rapidly than did the overall index. Medical care costs, however, were up only 0.3 per cent, equaling the smallest monthly increase in over two years.

According to preliminary estimates, the wholesale price index jumped 0.4 percentage point in September, rebounding to the July level of 109.1 per cent of the 1957-59 average. Most of the increase was accounted for by sharply higher prices of farm products and processed foods and feeds, which often fluctuate considerably from month to month. The index of industrial wholesale prices also moved higher, after several months of relative stability. However, this index has been significantly influenced by strike-related movements in copper prices since late last year. The very large drop in the prices of copper and copper-based products since the April labor settlement in the copper industry has held back the overall index, hiding somewhat the continuing upward movement in the wholesale prices of other industrial commodities. Copper prices had returned to pre-strike levels by August, and the September increase in the industrial wholesale price index reflected, in part, the reemergence of the underlying upward trends in the prices of many industrial commodities.



Note: Consumer prices are plotted through August; wholesale prices are plotted through September (preliminary).
Source: United States Department of Labor, Bureau of Labor Statistics.

Labor costs per unit of output jumped 1.6 per cent in August, the largest monthly increase since January 1967. The combination of increased labor costs in manufacturing and a sharp decline in productivity raised the index of unit labor costs in manufacturing to 112.0 per cent of the 1957-59 average. The productivity decline was mostly the result of the substantial drop in steel output without a commensurate reduction of hours worked in the industry.