The Business Situation

The economy expanded far more rapidly in the third quarter than most observers had expected a few months ago. Final spending registered a large gain, as personal consumption expenditures increased sharply and business fixed investment showed renewed growth. At the same time, total business inventory accumulation slowed only moderately despite the working-down of strike-hedge steel inventories. Consumer spending kept pace with rapidly expanding pre-tax personal incomes even though higher withholding rates, reflecting the 10 per cent tax surcharge, greatly limited the growth of disposable income during the quarter. A large part of the increase in consumption was financed by record use of consumer credit. As the quarter drew to a close, retail sales and a few other economic indicators appeared to ease slightly, but many others strengthened, including housing starts and new orders for durable goods.

The failure of business activity to slow appreciably in the third quarter—in the face of the fiscal restraint program and the decumulation of excess steel inventories—underscored the momentum of the economy and the strength of inflationary wage, price, and profit expectations. While the cumulative effects of fiscal restraint are likely to become more clearly visible as time passes, the delay in getting the economy back to a slower rate of growth has unquestionably complicated the task of restoring reasonable price stability and achieving the much needed improvement in our international trade balance.

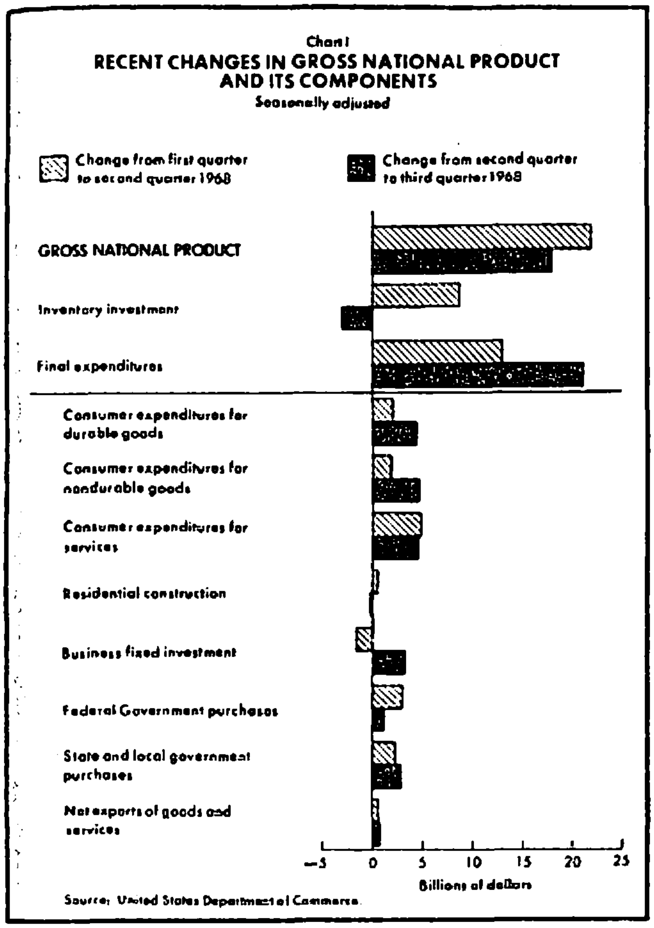
GNP IN THE THIRD QUARTER

The nation's total output of goods and services showed a strong further increase in the third quarter. According to preliminary estimates by the Department of Commerce, gross national product (GNP) climbed $17.9 billion (see Chart I) to a seasonally adjusted annual rate of $870.8 billion. While this was somewhat less than the record $21.7 billion GNP increase recorded in the second quarter of 1968, it still must be regarded as excessively large. Real GNP, which is an estimate of national product excluding the influence of price changes, grew at a 4.9 per cent annual rate in the third quarter, down somewhat from the very large increase of more than 6 per cent in both the first and second quarters of the year but still higher than what is generally considered sustainable in a full employment economy.

According to the preliminary data, there was a slowing in the rate of increase in the implicit price deflator, which converts GNP at current market prices into 1958 prices. This price measure rose at a 3.6 per cent annual rate in the third quarter, with roughly one fifth of the gain attributable to the July pay increase for Federal employees. In the preceding four quarters, the implicit price deflator had climbed at an average annual rate of about 4 per cent. Paradoxically, the third-quarter slowing of the overall GNP deflator was centered in the personal consumption component despite very strong demand for consumer goods and services. The consumer price index, which is a measure of prices paid by consumers that differs in both coverage and method of computation from the deflator for GNP consumption expenditures, rose at a 5 per cent annual rate in the third quarter, the steepest increase this year.

Heavy consumer spending, financed in large part by exceptional use of credit, was the predominant factor in the third-quarter GNP advance. Consumer purchases of goods and services rose by $13.4 billion, accounting for about 75 per cent of the quarter's total growth in GNP. The increase was a good deal smaller than the record spending surge of $17.2 billion in the first quarter but was nevertheless the third largest quarterly increase on record.

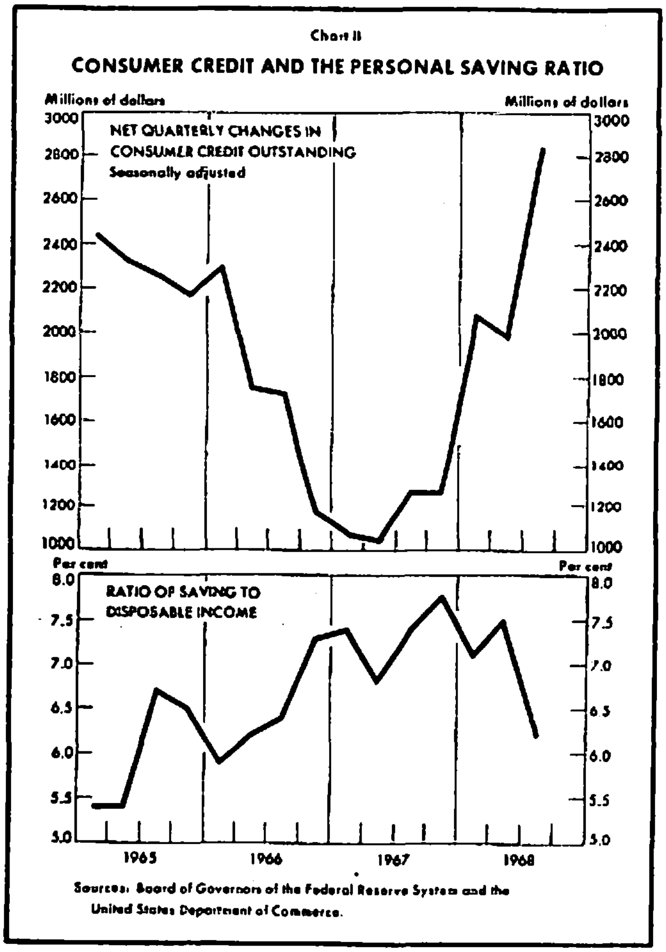
Most of the increase in consumption was accounted for by expanded purchases of goods, in both the durables and nondurables categories. Expenditures for services rose by an estimated $4.6 billion, an amount generally in line with the recent trend. Consumer purchases of nondurable commodities rose by 8 per cent at an annual rate, with spending on food and clothing accounting for most of the gain. Consumer buying of durables, led by surging auto sales, also turned sharply higher after only a modest second-quarter gain. Indeed, sales of new cars, including



imported vehicles, ran at an annual rate of roughly 10 million units throughout the summer. After introduction of the new models, sales of domestically produced autos continued strong; they rose to an annual rate of 9.0 million units in September and were unchanged in October. Reflecting the strength of consumer demand, the dollar volume of sales at retail outlets reached a record level in the third quarter. Sales advanced substantially in both July and August, but preliminary estimates indicate that retail buying slipped fractionally in September.

The increase of personal tax withholding rates in mid-July as the surtax went into effect resulted in a sharp reduction in the growth of disposable income. Thus, although total personal income—measured before taxes—continued to expand strongly in the third quarter, the increase in disposable after-tax income was the smallest in more than two years. Indeed, the quarter's $6.3 billion gain in disposable income was less than half as large as the $13.4 billion rise in consumption. As a consequence, the amount of income saved fell by an unusually large $7.2 billion. The rate of saving—personal saving as a percentage of disposable income—dropped to 6.2 per cent from the very high second-quarter figure of 7.5 per cent (see Chart II), the second largest quarter-to-quarter decline since the Korean war.

The big factor in the slowdown of saving was the record third-quarter expansion of consumer credit outstanding (also shown on Chart II). Rapidly increasing disposable income in earlier quarters had enabled consumers to build up their financial assets and still increase consumption spending with modest reliance on credit. This left individuals in a strong financial position and with relatively light loan repayment burdens, permitting them to turn heavily to instalment credit in the third quarter when the surtax slowed the growth of disposable income. Indeed, when expressed at an annual rate, consumer credit rose $11½



billion in the third quarter, about $3 billion more than in the first and second quarters.

The third-quarter surge in consumption expenditures apparently limited business inventory accumulation at wholesale and retail trade establishments. In fact, total inventories held by retailers and wholesalers are estimated to have shown no net change over the course of the third quarter. On the other hand, manufacturers' inventories expanded substantially, accounting for virtually all the $7.7 billion addition to total stocks indicated in the preliminary GNP estimates. These estimates, however, were based on data for only the first two months of the quarter and may well be revised substantially once complete data are available.

Business fixed investment moved ahead briskly in the third quarter, rising by $3.2 billion to an annual rate of $90.2 billion. This expansion was roughly in line with the pattern projected by the survey of business capital spending plans taken in August by the Department of Commerce and the Securities and Exchange Commission. The quarter's entire gain in capital investment was accounted for by equipment purchases; expenditures for construction of new plant remained virtually unchanged.

Residential construction spending was little changed in the third quarter, reflecting the drop-off of housing starts in May and June. At an annual rate of $29.4 billion, residential outlays were down by $0.1 billion from the second-quarter rate. However, new housing starts, which lead actual expenditures, advanced strongly through the summer and by the quarter's end had reached an annual rate of roughly 1.6 million units, equaling the peak levels recorded last spring. Strong demand for new housing and more readily available mortgage funds appear to be offsetting the restrictive influence of high mortgage interest charges, and the near-term outlook for the residential construction industry remains good. The prevalent view now is that the year 1968 will see more than 1.5 million housing units started, up sharply from the totals of 1.3 million and 1.2 million in 1967 and 1966, respectively.

Total purchases of goods and services by all levels of government rose $3.8 billion in the third quarter, the smallest gain in a year. Expenditures by state and local governments grew at a pace about in line with the rate of increase in 1966 and 1967. Federal Government purchases expanded by only $1.1 billion, much of which was accounted for by the July Federal pay raise. The increase in Federal spending was the smallest for one quarter since before the mid-1965 start of the Vietnam buildup. The slowdown in the growth rate of Federal outlays was divided about equally between defense and nondefense expenditures.

RECENT DEVELOPMENTS IN PRODUCTION AND EMPLOYMENT

Industrial production registered a second consecutive monthly decline in September, as falling steel output continued to be a depressing influence. The Federal Reserve Board's index of industrial output fell 0.5 percentage point to a seasonally adjusted 163.4 per cent of the 1957-59 average. Iron and steel output dropped 27 per cent in the two months following the July 30 labor contract settlement. Exclusive of iron and steel, industrial output was virtually unchanged through the third quarter after a full year of rather rapid advance. This leveling-off was widespread, with most sectors showing only marginal changes in either direction. Mining activity and motor vehicle production were down somewhat, utilities and consumer goods output were up a bit, and the index of equipment production was unchanged.

While manufacturing production remained about unchanged in the third quarter, new manufacturing capacity —which is primarily the result of plant and equipment spending decisions made several quarters earlier—climbed substantially. Consequently, the rate of capacity utilization dropped 1.4 percentage points to a five-year low of 83.3 per cent.

The short-term outlook for industrial production was bolstered in September, when new orders received by manufacturing establishments rose 3 per cent to a record level of $51.6 billion. The construction materials and steel industries registered particularly impressive gains, while new orders in the consumer durables sector turned higher after a two-month decline. Orders received by nondurable goods producers also advanced, roughly offsetting a decline in the volatile defense products industries. Manufacturers' shipments moved a good deal higher in September, but remained below the record level achieved in July. Manufacturers' new orders exceeded shipments in September by $400 million, increasing the backlog of unfilled orders to a level of $83.6 billion.

On balance, the employment situation shows little indication of easing from the very tight conditions which have prevailed for the last year or so. The total number of jobs in nonfarm establishments increased by 136,000 in October, and the gain would have been substantially larger but for a strike in the coal-mining industry. Employment in manufacturing concerns increased after two consecutive months of decline and surpassed the previous record level of last June. Federal Government employment eased for the fourth consecutive month, reflecting the Congressional restrictions on replacement hiring. Employment in the remaining sectors of the economy was strong except in mining, where payrolls declined by 50,000 because of strikes, and in transportation and utilities, where employment was unchanged. The overall unemployment rate remained unchanged in October at 3.6 per cent of the civilian labor force. There was a slight increase in the very low unemployment rate for adult men, but a small decrease for adult women.

PRICE AND COST DEVELOPMENTS

The rate of advance in the consumer price index eased somewhat during September. After climbing at a 4 per cent average annual rate for about a year, the index surged to a 6 per cent rate in June and July, returned to a 4 per cent rate in August, and then slowed to a 3 per cent advance in September. However, nearly all the September slowdown in the overall index was due to a leveling-off of food prices following rapid increases earlier. The consumer price index excluding food climbed at an annual rate of just under 4 per cent in September, only marginally below the advances of preceding months. Increased prices of clothing led the continued rise in commodities prices, while higher housing and medical care costs contributed to the further rapid climb in the cost of services.

Preliminary October data indicate that the wholesale price index was unchanged from the September level of 109.1 per cent of the 1957-59 average. The overall index has been stable since July, but price movements in various commodity groups suggest continued upward pressures in many important areas. Indeed, in October the industrial commodities price index rose at an estimated 4.4 per cent annual rate, the largest one-month gain since February of this year. During most of the spring, the rise in the industrial index was slowed by a rapid decline in prices of copper and copper products, following the settlement of the long strike in that industry. By midsummer, the copper price readjustment had been completed. Since that time the continued increase in the prices of other products has been manifest in the accelerating rise in the price index of all industrial commodities. On the other hand, prices of farm products and processed foods and feeds have been fluctuating for several months but have shown a generally downward trend since July. This downtrend has been the principal factor in the stability of the overall wholesale price index, offsetting the increases in industrial prices.

Labor costs per unit of output in manufacturing jumped 0.8 percentage point in September to a record level of 112.7 per cent of the 1957-59 average. Following the pattern set in August, the gain was due to a combination of higher labor costs per man-hour and an actual drop in productivity. Labor costs have been rising sharply for some time, but the decline in output per man-hour is a recent development, probably resulting in large measure from a steeper reduction of steel output than of hours worked in the steel industry.