The Business Situation

Concrete signs of a needed moderation in the rate of economic expansion have remained meager thus far in 1969. Recently received information indicates that demand continued to be excessive and inflationary as the old year ended, although pressures in the consumer sector tended to ease somewhat. The gross national product advanced vigorously in the October-December quarter, the labor market tightened further, and prices continued to soar. The relatively small increase in personal consumption expenditures was apparently responsible to some degree for a substantial accumulation of inventories at the retail trade level. The 10 percent tax surcharge was very likely an influence on consumer behavior, but the fundamental trend of consumer demand was obscured by the dampening effects of the widespread outbreak of flu. The magnitude of the fourth-quarter advances in industrial production, business fixed investment, residential construction, employment, and prices left little doubt regarding the exuberance of the economy as 1968 drew to a close. It is clear that the task of restoring a satisfactory degree of price stability will be long and difficult.

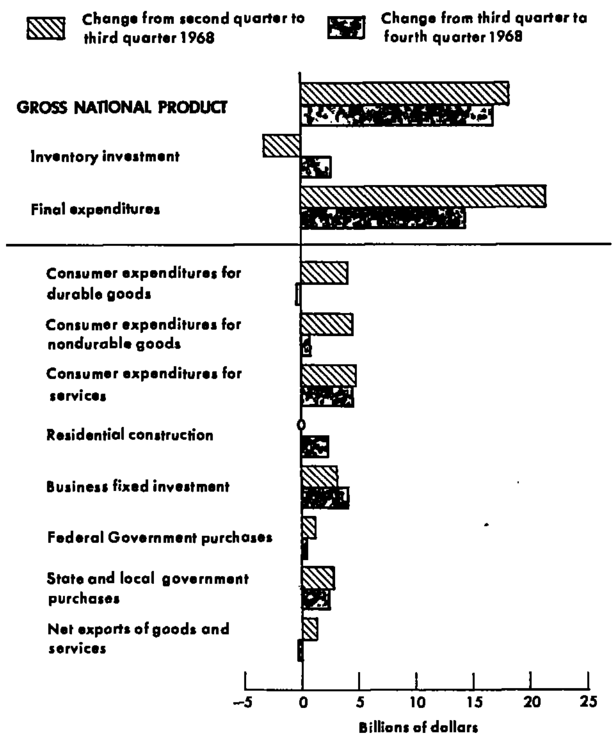
GROSS NATIONAL PRODUCT IN THE FOURTH QUARTER

The nation's total output of goods and services (GNP) increased by $16.8 billion in the final quarter of 1968 (see Chart I) to a seasonally adjusted annual rate of $887.8 billion, according to preliminary estimates by the Department of Commerce. This represented only a very modest slowing from the previous quarter's $18.1 billion advance. Of the total fourth-quarter expansion in demand, a bit more than half reflected simply higher prices. The implicit GNP price deflator—a broad, summary measure of price developments in all the components of national output—increased at an annual rate of just under 4 percent, exceeding the third-quarter pace of 3½ percent and equaling that recorded during the first half of 1968. The proportion of GNP growth consisting of real expansion—that is, the rise in output excluding the effect of price changes—diminished quarter by quarter through the year, giving clear evidence of the disturbing grip of inflationary forces. In the final quarter, real GNP increased at an annual rate of 3.8 percent.

Chart I

RECENT CHANGES IN GROSS NATIONAL PRODUCT AND ITS COMPONENTS

Seasonally adjusted annual rates



Source: United States Department of Commerce.

The composition of the fourth-quarter gain in GNP differed markedly from that of the third-quarter increase. Generally speaking, private investment displaced consumer spending as the primary source of growth. Personal consumption expenditures rose by only $5.2 billion, considerably less than the third-quarter advance of $13.2 billion and the smallest since a like increase in the third quarter of 1967. Meanwhile, business increased its investment outlays for both fixed capital and inventories by $6.6 billion. Inventories were accumulated at a rate $2.5 billion above the pace of the third quarter, when there had occurred a decline of $3.3 billion in the rate of accumulation due to the working-off of strike-hedge steel inventories. The growth of final expenditures in all sectors—i.e., total expenditures less inventory accumulation—amounted to $14.3 billion, substantially below the $21.4 billion increase recorded in the previous quarter.

Consumers spent in the fourth quarter only a little over half of the $9.8 billion increase in disposable personal income. This cautious behavior marked a sharp shift from the third quarter, when income growth had been severely curtailed by the imposition of the tax surcharge and yet consumer spending had advanced by more than double the increase in disposable income. The savings rate rose in the fourth quarter to 6.9 percent from the preceding quarter's 6.3 percent, although it remained below the unusually high rates of late 1967 and early 1968. It seems quite possible that consumers were finally reacting to the effects on spendable income of the tax surcharge, and they may also have been anticipating the higher social security payments that started this January. The impact of these tax increases on recent expenditures is difficult to assess, however, especially since the widespread outbreak of flu toward the end of the year probably cut into retail buying. Whatever the causes, consumer demand for goods, as distinct from services, was on a plateau in the fourth quarter. Expenditures for durable goods declined slightly and expenditures on nondurable goods rose modestly, leaving a net gain of only $0.5 billion. The reduction in demand for durables was the first in five quarters, with a dampening in the pace of auto sales contributing significantly to the decline. Moreover, the increase in demand for nondurables was the smallest since an actual decline occurred in the final months of 1963. Most of the $5.2 billion rise in consumption during the quarter was in services. Such expenditures rose by $4.6 billion, an increase in line with the trend over the past few years.

Sales at retail outlets dropped about 2 percent in December, according to the preliminary report; this brought sales down to the lowest level since May. The weakness in sales was widespread, as it was for the quarter as a whole. It was particularly marked in the auto sector. In terms of the number of units sold, auto sales slid from a seasonally adjusted annual rate of just over 9 million in October, which was close to the average for the third quarter, to a bit under 9 million in November, and then to a rate of 8½ million units in December. Despite this slackening in the sales pace, over 8.6 million new domestic-model cars were sold in the United States market during the year, the highest annual total since 1965. In the early weeks of 1969, however, sales were running below the December pace.

The record increase in investment spending was the major factor propelling the economy in the fourth quarter. In addition to the $2.5 billion rise in the rate of inventory accumulation, fixed investment advanced by $6.4 billion, in dollar volume a record and in percentage terms the largest gain since early 1959. Of this increase, almost two thirds

($4.1 billion) comprised business capital investment; this latter gain resulted primarily from a record $3.1 billion surge in spending for equipment. According to a recent McGraw-Hill survey, the strength of demand for capital goods has rested partly on a desire to beat price rises, partly on anticipation of growing demand, and also —in significant degree—on a need to cut labor costs.

Expenditures for residential construction in the fourth quarter grew by $2.3 billion, the largest quarterly advance of the year. At a seasonally adjusted annual rate of $31.8 billion, such outlays were some $3½ billion above the year-earlier pace and more than $10 billion above the low reached in early 1967 at the depth of the slump in home building. Although outlays for residential construction in December registered another large gain, private housing starts plummeted that month to an annual rate of 1.45 million units, more than offsetting the sharp rise in November to the extraordinary rate of 1.72 million units. This is a highly volatile series, however, and both the November and December movements may have largely reflected statistical aberrations. Data on building permits showed a milder jump in November and but little softening in December, with the permit rate in the latter month exceeding the pace in all but two other months of the year. Some observers are concerned regarding the prospects for residential construction activity in 1969, as heavy business demands for funds threaten to put increasing pressure on the supply of mortgage funds. Housing industry spokesmen, however, remain guardedly optimistic. Last month, in order to improve the flow of funds into the mortgage market, the interest rate ceilings on home loans insured by the Federal Housing Administration as well as on loans guaranteed by the Veterans Administration were raised to 7½ percent from 6¾ percent.

Government purchases of goods and services increased by $2.9 billion in the September-December period, the smallest rise since the third quarter of 1967. State and local government expenditures accounted for most of the increase. The Federal Government was responsible for only $0.4 billion of the gain, largely representing defense spending. Thus, Federal Government expenditures contributed very little to the increase in inflationary pressures in recent months.

The remaining component of GNP, net exports of goods and services, declined $0.3 billion during the quarter, compared with a $1.3 billion advance in the third quarter. During the year as a whole, net exports of goods and services dropped precipitously, from $4.8 billion in 1967 to $2.4 billion. This was the smallest surplus since 1959, a consequence of the disturbing deterioration in our merchandise trade position.

RECENT DEVELOPMENTS IN PRODUCTION AND EMPLOYMENT

Industrial output registered another substantial gain in December. The Federal Reserve Board's index of industrial production climbed 0.9 percent to a seasonally adjusted 168.9 percent of the 1957-59 average. Reflecting the strength of capital goods demand, production of business equipment again increased more rapidly than total output. Indeed, output of business equipment rose by 5 percent between August and December while total industrial production gained 2½ percent. This surge in business equipment followed several quarters of virtual stability. It contrasted with the output of defense-oriented equipment, which fell 5 percent during those months after about three years of steady growth. Consumer goods output rose in December by only 0.3 percent. The modest size of the increase was largely attributable to cutbacks in auto and television production. The seasonally adjusted annual rate of auto assemblies had run for several months at a high plateau of about 9¼ million units, but in December slid off to below 9 million units. In January, as the sales pace declined and inventories swelled, production was cut back further and schedules for February call for additional reductions.

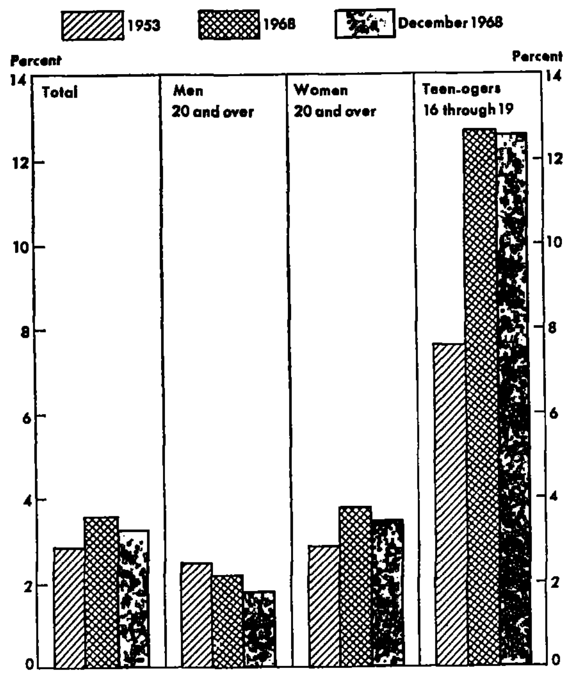
The production of materials recorded a sizable advance in December. The steel industry continued its swift recovery following the depletion of strike-hedge stockpiles, and it appears that steel production is now at a rate close to that which prevailed before the strike-anticipating inventory buildup. In January, steel production continued to move up, perhaps partly as a result of the strike by East and Gulf Coast longshoremen which has curbed imports. An increase in coal production, reflecting further recovery from the October strike, also contributed significantly to the December gain in materials output.

The volume of new orders received by manufacturers in December increased very slightly. A small drop in orders for nondurable goods was more than offset by a rise in orders for durables, principally a result of an increase in electrical machinery orders. At the same time, the backlog of unfilled orders registered its sixth successive gain, partly due to a sizable drop in shipments. Manufacturers' inventories also increased again, but the magnitude of the accumulation was by no means inordinate. While the inventory-sales ratio of manufacturers rose substantially, the ratio was close to the average for the year.

At the year-end, the manpower required for continued expansion of production was placing a heavy strain on the nation's labor resources. The seasonally adjusted unemployment rate held in December at the fifteen-year low of

3.3 percent that was reached in November. At that level, it is true, the rate was almost one percentage point above the low of 2.5 percent attained in May and June 1953 during the Korean war; the average for the entire year of 1968 (3.6 percent) was 0.7 percentage point higher than the 1953 average (see Chart II). Nonetheless, a breakdown of the total into various groups suggests that in some respects the economy may currently be experiencing the greatest excess demand for labor since World War II. The unemployed in today's labor market do not form a reservoir that serves to dampen in any effective way the upward surge in wages. Especially significant in December was the further tightening of the labor market for men 20 years of age and older, as their unemployment rate sank to a post-World War II low of 1.8 percent. For the full twelve months of 1968 their unemployment rate averaged only 2.2 percent, compared with 2.5 percent in 1953. While the 1968 unemployment rate for adult women, 3.8 percent, was considerably above the 2.9 percent prevailing in 1953, the December rate was down to 3.5 percent. Most striking was the unemployment rate for teen-agers, which was very much higher than in the Korean war period. This three-way breakdown, as well as other evidence, indicates that at the present time the unemployed consist largely of those seeking part-time or temporary work or who lack the skills required for the types of jobs that are open.

Chart II
UNEMPLOYMENT RATES
IN 1953, 1968, AND DECEMBER 1968



Source: United States Department of Labor, Bureau of Labor Statistics.

PRICE DEVELOPMENTS

Wholesale prices advanced steeply in January, according to preliminary data, with the wholesale price index increasing by 0.8 percent, the largest rise since July 1953. Prices of industrial commodities continued to soar, climbing 0.5 percent; this was the biggest monthly jump since August 1956. A sharp boost in nonferrous metals prices coupled with another sizable increase in lumber and plywood prices accounted for most of the gain. Final December data indicate that the wholesale price index was 2.8 percent higher than in December 1967. The rise in the index of industrial commodities was nearly as large.

The consumer price index in December was 4.7 percent above the year-ago figure, the biggest December-to-December increase since early in the Korean war. The month's gain in the index was the smallest since September 1967 but nonetheless was at an annual rate of 3 percent. A partly seasonal drop in the prices of nonfood commodities, led by a decline in new and used car prices, was responsible for the deceleration. According to the Bureau of Labor Statistics, the January rate of increase was probably up again.