The Business Situation

It appears increasingly clear that the tax surcharge enacted last June has restrained consumer spending in recent months. Retail sales in January, though up from the depressed December reading, were at a level no higher than in mid-1968. Nonetheless, consumer behavior has been highly unpredictable in the past few years and a resurgence of consumer demand cannot be ruled out, especially in view of the currently high rate of personal saving. At the same time, there are no indications that business fixed investment, state and local government spending, and residential construction—all of which were important factors boosting the economy in the final months of last year—have lost any of their momentum, and settlement of the dock strike should push net exports up sharply over the near term. Industrial production has continued to move up, the labor markets remain extremely tight, and price increases continue to be excessive.

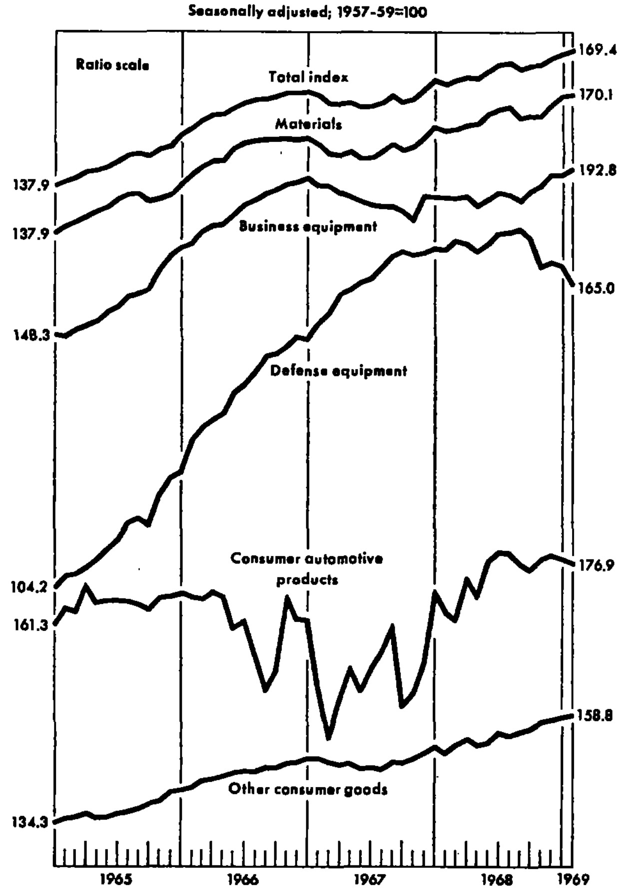
OUTPUT, INVENTORIES, AND CONSTRUCTION ACTIVITY

The Federal Reserve Board's index of industrial production recorded its fifth consecutive monthly gain in January, when the index rose 0.5 percentage point to a seasonally adjusted 169.4 percent of the 1957-59 average (see Chart I). The January increase was, however, more modest than the large advances recorded in each of the final three months of 1968.

The January estimates indicate that production of defense-oriented equipment was sharply below last summer's peak, and this remains true after allowance for a strike at a major aircraft producer during the month. On the other hand, a sizable further gain in business equipment output provided additional evidence that the surge in capital investment which began last summer is continuing.

Materials output rose very little in January and much less than in the preceding four months. The strength in this sector through the past fall and early winter was due in large measure to the rapid recovery of steel production from the low point that followed the labor settlement in that industry at the end of last July. Steel industry operations now appear to have recovered to a more normal level, however, and are thus providing less thrust to the expansion of total industrial production. Steel industry

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.

output recorded a gain in January of about 2 percent, and it appears that output increased in February by a comparable amount.

The output of consumer goods remained strong in January despite another decline in the production of automotive products. Most household goods, with the exception of television sets, registered healthy gains. The weakening in the automotive sector is reflected in figures on new car assemblies. Auto production slipped to an annual rate of 8.7 million units in January from the preceding month's 8.9 million unit pace, and fell further in February to an annual rate of about 8½ million units. Since dealers' inventories are very high, the industry has recently been curtailing production to realign output with the somewhat reduced auto sales pace that developed last fall.

Total inventories of manufacturing and trade firms registered a further sizable gain in December.[1] Total business sales declined in that month, moreover, and the overall inventory-sales ratio increased to the highest level of the year. The retail trade sector experienced a very large rise in the ratio of inventories to sales. The ratio also increased in manufacturing during December, but in January a strong increase in manufacturers' shipments, together with a small further rise of inventories, brought the ratio for manufacturing back down.

It is, of course, too early to assess the significance of the recent move to higher levels of retail trade inventories relative to sales. Part of the accumulation of stocks in the final months of 1968 was undoubtedly involuntary—i.e., due to a failure of sales to come up to levels expected when earlier inventory buying decisions were made. On the other hand, some of the recent softness of sales may have little longer run significance. This is especially true of the December downturn, in view of the influenza epidemic that swept the country that month. Indeed, according to the advance report retail sales recovered in January, and new auto sales showed renewed strength in February. Total retail sales, however, remain below the peak reached in August of last year.

Although new orders received by all manufacturing firms edged down very slightly in January, they were well above the levels of most months of last year. New orders received by manufacturers of durable goods actually rose slightly, but this was offset by a decline in orders received by nondurables producers. Shipments of durables increased rather strongly in January but remained a bit below the level of new orders. Thus, the backlog of unfilled orders on the books of durables manufacturers rose further, continuing the uptrend that began last August.

Recent months have witnessed unusually wide swings in housing starts. Although the rate of private housing starts is highly volatile, gyrations of the magnitude of those of recent months are atypical; the number of housing units started rose solidly in November, dropped markedly in December, and then increased steeply in January to a 1.8 million unit annual rate, the highest figure since early 1964. On the other hand, the number of new residential building permits issued, which tends to change more smoothly than starts, showed a fairly consistent, rising trend from last May, but dropped sharply in January, casting some doubt on the significance of that month's steep gain in starts.

EMPLOYMENT, INCOME, AND CONSUMER DEMAND

A boost in the already strong demand for labor has been apparent recently in the resumption of rapid growth in employment and in the labor force as well. Employment advanced by more than 450,000 persons in January, bringing to 1.2 million the total increase since last October when employment growth began to accelerate. At the same time, the civilian labor force has also been growing at an unusually rapid pace. In January it stood at nearly 80 million persons, an increase of more than 1 million since last October. In contrast, there had been a decline in the civilian labor force of 100,000 persons in the June-October period of last year. The recent strong rise in the labor force has of course accommodated some of the accelerated employment gains, but the unemployment rate has nevertheless dropped rather markedly. From 3.6 percent in October, the unemployment rate fell progressively to 3.3 percent in December and held at that fifteen-year low in January.

The strength of labor demand has also been apparent in the number of workers on nonagricultural payrolls. Employment in nonagricultural establishments increased substantially in January for the fourth consecutive month. The sizable January gain, amounting to a quarter of a million persons, was concentrated in the trade and service industries, reflecting both the rapid secular growth of employment in those sectors and, especially in trade,

[1] The Department of Commerce has revised upward the gross national product (GNP) estimate of fourth-quarter inventory accumulation to an annual rate of $10.6 billion from the preliminary figure of $10.0 billion discussed in the February issue of this *Review*. Consumption expenditures and state and local government spending were also revised upward. However, these adjustments were more than offset by a sharp downward revision in net exports, and the estimate of fourth-quarter GNP was reduced by $0.4 billion.

some recovery from the dampening effects of the flu outbreak in December. The average workweek in manufacturing held steady at 40.7 hours but remained below the high of 41.1 hours set in September.

Recently released figures on labor costs emphasize once again the severity of the inflationary problem that confronts the economy. Labor compensation per man-hour in the private economy increased by 8 percent between the final quarter of 1967 and the corresponding period in 1968, the sharpest over-the-year advance since 1956. Comparing the full year 1968 with the preceding year, the rise in compensation per man-hour was nearly as great, amounting to 7½ percent and the highest since early in the Korean war. The impact on unit labor costs of the swift advance in hourly compensation was softened to a considerable extent, however, by a healthy gain in output per man-hour. Productivity in the overall private economy was up by 3.3 percent in 1968, and unit labor costs thus averaged 4 percent above the preceding year. Although a productivity gain of the size registered in 1968 is considered to be close to the long-run trend, it was due in part to an acceleration of real growth in 1968 following a significant slowing in 1967.

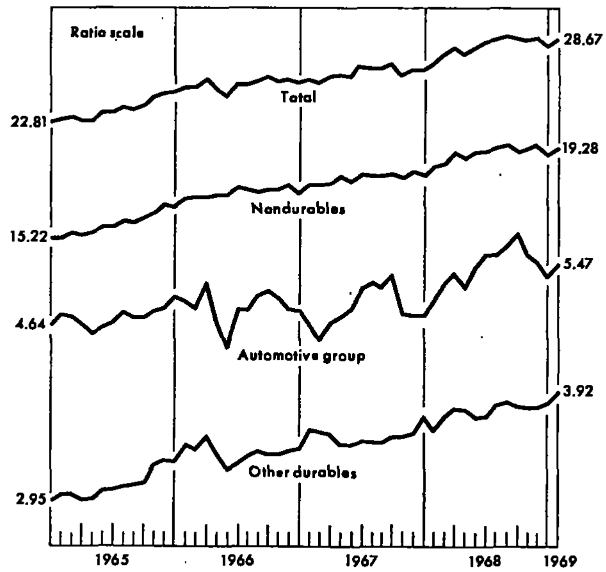
The Commerce Department has reported that personal income rose by only $1.6 billion in January to a seasonally adjusted annual rate of $715.1 billion. Although this was the smallest gain in over a year, the size of the increase was trimmed by nearly $1.8 billion because of the January 1 boost in social security contributions. Moreover, major strikes—of longshoremen at Atlantic and Gulf Coast ports and of some workers at petroleum refineries—tended to slow the increase in aggregate wage and salary disbursements. On the other hand, wages and salaries in the trade sector made a strong recovery after having fallen in December for the first time in over two years, a decline apparently caused by the widespread outbreak of the flu.

Although retail sales volume in January recovered most of the December drop, according to advance data, total sales at retail outlets remained below all other months since June of last year (see Chart II). The weakness of sales in the automotive group has been a dominant factor restraining overall retail volume, but even excluding this component retail sales have shown little movement since last July, when the 10 percent tax surcharge went into effect. Consumer spending in the opening months of 1969 may also be affected by the higher social security contributions that went into effect January 1, and still further by the heavy final payments of 1968 income taxes that are expected to result from the retroactivity of the tax surcharge. The Federal minimum wage was increased for more than 2 million workers on February 1, but this is expected to supply only a small boost to total disposable income.

Chart II

RETAIL SALES

Billions of dollars; seasonally adjusted



Note: Latest data plotted are based on advance reports.

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

In this connection, the Commerce Department's quarterly survey of consumer buying expectations taken in January suggests a continued downward drift in new car sales, unchanged used car sales, and a little softening in expenditures on houses. The only sizable advance indicated by the survey is in purchases of household durables, a finding that is consistent with the recent heavy demand for new apartments and homes. The survey results imply a rate of new car sales in the first half of 1969 close to the pace of the comparable period in 1968, when sales of domestic models averaged a seasonally adjusted annual rate of 8¼ million units. Actual sales volume appears to be moving a bit above this projection. Sales of domestic models were at a seasonally adjusted annual rate of 8½ million units in December and averaged about the same rate in January and February combined. The sales pace reached 8¾ million units in February, but this may have involved some purchases deferred from January when the sales rate dropped to 8¼ million units. This recent performance represents a weakening when compared with the average sales pace of about 9 million units sustained from July through November.

PRICE DEVELOPMENTS

A steep increase in the prices of services lifted the January consumer price index to a new high. While the overall index rose at an annual rate of roughly 4 percent, the services component jumped at a rate of nearly 8 percent. The sharp advance in the services area was the largest in six months and was appreciably above the 5½ percent increase registered in all of 1968. Unusually large gains were reported in the costs of auto ownership and operation—insurance, registration, driver's license fees—and in home ownership costs. Food prices also continued to climb swiftly, but prices of nonfood commodities edged lower for the second consecutive month. Although the rate of advance in the overall consumer price index has slowed a little in the latest two months, the prospects for a continuation of this slower uptrend are questionable in light of soaring wholesale prices. The January advance for industrial commodities was not only exceptionally large but reflected price increases spread over a very broad range of goods. It is too early to determine whether price rises in February were as widespread, but preliminary data indicate another very substantial advance in industrial wholesale prices.