The Business Situation

The level of business activity continues to expand, though the pace varies rather widely among the key sectors of the economy. New survey evidence suggests that business capital spending may continue rising into 1970, in part because of delays in project completions experienced this year. At the same time, the balance between inventories and sales remains relatively conservative by recent past standards, and further inventory building could supply economic thrust in the months ahead if business sales expectations remain strong. Modest consumer spending and declining residential construction are currently helping most to slow the rise of aggregate demand and to limit inflationary pressures from the demand side. However, the recent large Federal pay increase may tend to lift consumption spending over the near term.

Meanwhile, industrial production continues to increase, new orders received by durable goods manufacturers have about recovered earlier declines, and the labor markets remain tight. On balance, the inflationary situation seems to have changed little over the course of this year, though this is not surprising in view of the usual delay with which restrictive monetary and fiscal actions influence economic activity and price behavior. Indeed, because the current period of inflation has continued for so long—about four years—considerable time may be required to restore price stability.

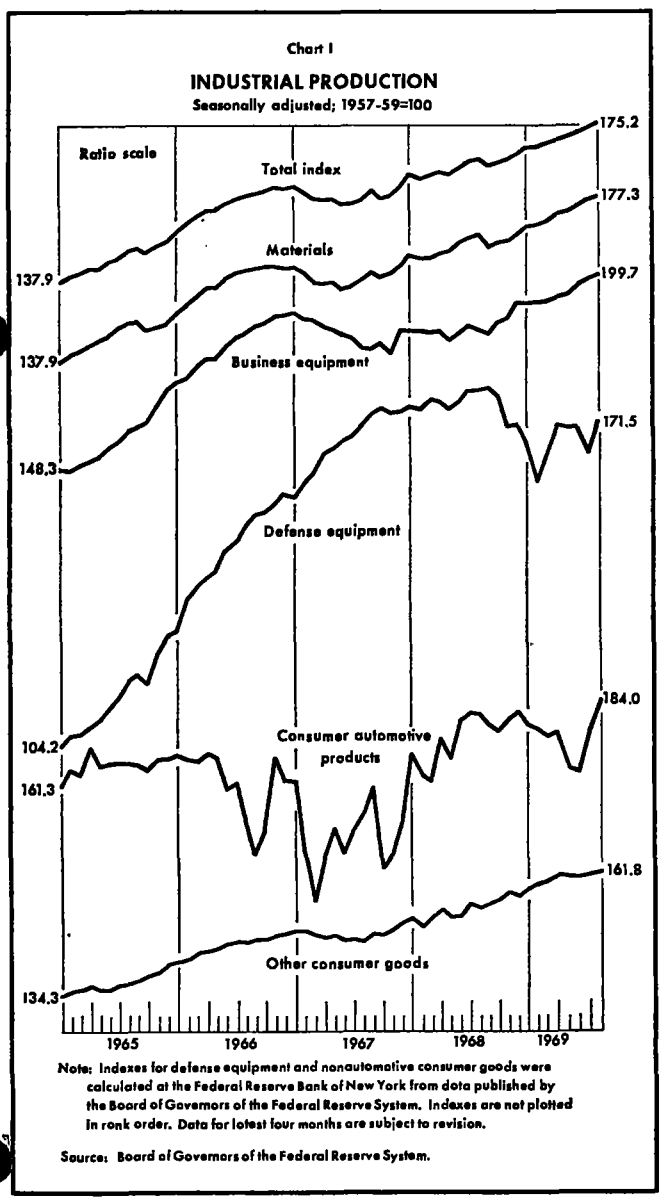
PRODUCTION, ORDERS, AND INVENTORIES

Industrial output rose strongly again in July when production of iron and steel, business equipment, and automotive goods all advanced. The Federal Reserve Board's seasonally adjusted index of total industrial production increased 1.3 percentage points to 175.2 percent of the 1957-59 average (see Chart I). The production index has climbed without interruption this year, and from December through July the annual rate of increase was a vigorous 6.6 percent. An important factor in this strength has been the rapid climb in iron and steel production, which by July had reached a level 20 percent above that prevailing at the end of last year. In the last few months the steel firms have been operating at close to full capacity, and the industry continues to forecast a high level of activity through the fourth quarter. The relatively ready—if unhappy—acceptance of the recent steel price increases underscored the strength of steel demand as well as the ability of steel consumers to pass along higher costs in today's firm markets.

Much of the gain this year in iron and steel output has stemmed from the high and rising level of activity in the capital goods industries. Production of business equipment continued to expand rapidly in July, growing by almost 1 percent in that month alone. From the end of 1968 through July, output of business equipment rose at an annual rate of 8 percent. Production of defense-related goods also increased sharply in July, mainly reflecting the settlement of two major labor disputes that had earlier limited output in this sector.

Paralleling the rather mild uptrend in total consumer demand, output of consumer goods has grown much less rapidly in recent months than that of either materials or equipment. Excluding the automotive sector, production of consumer goods has been virtually unchanged since early this year. In the first seven months of 1969, the production index for automotive products—which accounts for one tenth of the consumer goods portion of the index and includes production of parts as well as cars—actually averaged less than the figure for the full year 1968. In the January-July period auto assemblies by domestic producers averaged a seasonally adjusted annual rate of 8.3 million units, compared with a total 1968 output of 8.8 million units. Labor problems have played a part in this year's lower production rates, but dealer sales of domestic cars have also fallen from the 1968 level. The month-to-month movement of auto production has been somewhat erratic of late; scattered strikes significantly reduced assemblies in April and May but output surged in June, when the labor situation calmed. The industry initiated its annual model changeover in July—somewhat earlier than usual—and actual production slumped. However, after allowing for the earlier timing of the changeover, the seasonally adjusted assembly rate rose further in July from the June level. To some extent, this increase may reflect the fact that changes in the 1970 models were

unusually minor and involved little downtime for retooling. Because of the spring strikes and the earlier changeover date, the auto producers had expected to have relatively small carry-over stocks of old models, providing a tighter market for the introduction of the 1970 models. However, sales of domestic-model cars dropped in July and August to a seasonally adjusted annual rate of 8.1 million units, after averaging close to 8½ million units in the first half of the year. This July-August decline in sales left the industry at the start of the new-model year with about the same number of old-model cars as in 1968.



The often volatile series on new orders received by manufacturers of durable goods climbed to $30.5 billion in July, up $1.3 billion from June. A sharp recovery in defense-related orders accounted for almost all the latest rise. In the previous two months the total volume of new orders had fallen substantially, but the declines were mostly in the defense area. Orders for machinery and equipment eased $0.1 billion in July to $6.4 billion. This series peaked at $7.1 billion in April, around the time of President Nixon's recommendation for repeal of the investment tax credit, but aside from that month's spurt machinery and equipment orders have been running at about $6½ billion per month throughout this year.

Manufacturers' inventories were little changed in June after increasing strongly for several months, while trade inventories—chiefly at retail stores—turned in a sizable increase.[1] Shipments in June also showed a mixed pattern, as sales at retail and wholesale edged off whereas manufacturers' shipments rose sharply. Thus, the inventory-sales ratio for trade firms edged up and the ratio in manufacturing dropped significantly. On balance, however, for all businesses combined the inventory-sales ratio in June was at its low for the year. In July, manufacturers' shipments were about unchanged while total inventories rose by $1 billion, with durables manufacturing accounting for all the increase. As a result, the inventory-sales ratio for all manufacturing firms moved back up to about the average level of the past year and a half. The ratio for durables manufacturers increased to a level on the high side of the range prevailing since late 1967, but that for nondurables manufacturers dropped to a sixteen-year low.

CAPITAL SPENDING AND RESIDENTIAL CONSTRUCTION

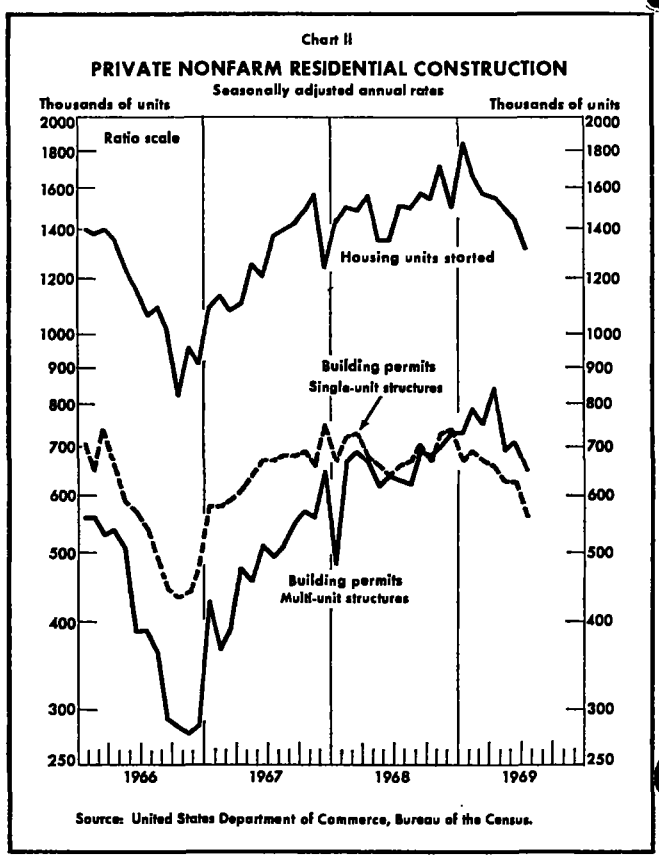
The capital spending boom appears to be losing some of its earlier strength, but new evidence also suggests that it may prove longer lived than earlier studies had indicated. A very recent survey by the Department of Commerce and the Securities and Exchange Commission found that businesses have revised downward their plant and equipment spending plans for this year. Businessmen now plan, according to this survey, expenditures of $70.9 billion

[1] The Department of Commerce has revised its estimate of the gross national product (GNP) for the second quarter of 1969. The estimate of inventory accumulation was revised downward by $2.6 billion to $6.9 billion at a seasonally adjusted annual rate. Consumption was revised up by $2.1 billion to $572.8 billion, and total GNP was revised down by $0.3 billion to $924.8 billion.

for new plant and equipment, or 10.6 percent more than was spent in 1968. An earlier Commerce-SEC survey taken last spring had indicated that outlays in 1969 would be about $1.3 billion higher than the latest reading. A recent McGraw-Hill study found much the same lowering of sights on 1969 spending plans, but concluded that the downgrading reflected some stretching-out of spending into 1970. Thus, the McGraw-Hill survey, which also queried businesses about their 1970 plans, found that they expect outlays to continue rising next year to a level 5 percent above this year. If realized, these results would imply some continued stimulus from business capital spending, though less than in the past year or so.

In contrast to the strength in business spending for plant and equipment, activity in residential housing has weakened substantially in the last few months (see Chart II). Private nonfarm housing starts began the year on a strong note, averaging a seasonally adjusted annual rate of 1.7 million units in the first quarter, up 0.1 million from the average of the final quarter of last year. Following their January peak, however, starts fell steadily to an average annual rate of 1.5 million in the second quarter. The July decline amounted to a particularly large 127,000 units, bringing the starts rate down to 1.3 million units. The number of housing permits issued by local authorities also dropped in July. Housing permits have declined for multi- as well as for single-unit buildings in the last few months. Earlier in the year, multi-unit construction showed considerable strength, running counter to the downward trend in single units.

The data on housing starts and permits encompass only those housekeeping units that are in conventional homes or apartment buildings. That is, these series measure output of the construction sector. Data on mobile home production are excluded from the starts and permits series, since they are classified as output of the manufacturing sector. Nevertheless, mobile homes are becoming an increasingly significant part of the supply of new housing. This market is an especially important source of low cost housing: in 1968 mobile homes accounted for 90 percent of all new housing units which sold for under $15,000. Perhaps reflecting their growing price advantage, the demand for mobile homes has increased very rapidly in recent years. Production rose from a level of 150,000 units in 1963 to over 300,000 in 1968, and industry spokesmen believe output will reach 400,000 units this year. Purchase of mobile homes has traditionally been financed through consumer instalment loans, but the Federal Home Loan Bank Board has recently proposed a regulation that would allow Federally chartered savings and loan associations to extend mortgage loans on mobile homes.



EMPLOYMENT, PERSONAL INCOME, AND RETAIL SALES

The employment situation generally remains very tight. According to the household survey, total civilian employment rose by over 300,000 in August, the third consecutive month of strong increase. The civilian labor force also expanded sharply but not so much as employment, and the unemployment rate edged down by 0.1 percentage point to 3.5 percent. The payroll survey also showed a large employment increase at nonagricultural establishments in August, following a slight decline the month before. About two thirds of the latest advance in payrolls occurred in manufacturing, but the average workweek in manufacturing moved down a bit.

Personal income recorded a large $6.2 billion advance in July, when the pay raise for Federal Government employees went into effect. Total wage and salary disbursements rose by $5.0 billion, but half of that increase was due to the larger paychecks of Federal workers. Outside

the Government, the July gain in income was relatively small, in part reflecting the fairly weak performance of payroll employment in that month.

Consumer demand still shows little buoyancy. Retail sales declined in May and June, and in July are estimated to have fallen by another $200 million to a seasonally adjusted level of $29.2 billion. These recent movements were in line with the weak trend in sales that has prevailed for nearly a year. Retail sales averaged $28.8 billion monthly in the third quarter of 1968, eased to an average of $28.6 billion in the fourth quarter, and then climbed by about $0.4 billion in both the first and second quarters of this year. A good part of this sluggish showing can be attributed to the auto sector. Sales of new domestic-model cars ran at a seasonally adjusted annual rate of 9.0 million units in the third quarter of 1968, but then edged down to 8.8 million units in the final three months of last year and dropped further to 8.4 million units in the first quarter. Sales steadied at an annual rate of 8.5 million units in the April-June period, but declined during July and August to a seasonally adjusted rate of 8.1 million units.

THE PRICE SITUATION

It appears that since last fall the dollar value of total consumer purchases at retail stores has not kept pace with the rising level of prices. The dollar volume of retail sales has risen since last September at an annual rate of less than 2 percent, but the retail price level—as estimated by the consumer price index excluding service costs—has advanced at an annual rate of over 5 percent. During the same period the total consumer price index rose at an annual rate of just under 6 percent. In July, the consumer price index increased further at a 5½ percent annual rate, with the major part of this gain resulting from higher food costs. Excluding food, prices rose at an annual rate of over 3½ percent.

At the wholesale level, the sharp run-up of prices of farm and food products has moderated. According to preliminary figures, the index of farm and food products dropped by almost 1 percent in August after remaining unchanged in July. Apparently because of a rapid increase in demand in the face of a somewhat reduced supply, agricultural prices had climbed at an annual rate of over 17 percent in the second quarter. The August decline apparently largely reflected a seasonal increase in supplies. There is some doubt that these price reductions will be passed on to consumers because the earlier increases in retail food prices had not kept pace with those at wholesale. The preliminary estimate of wholesale prices for industrial commodities indicates a sizable rise in August,

resulting in good part from price increases for steel and several other metals.