The Business Situation

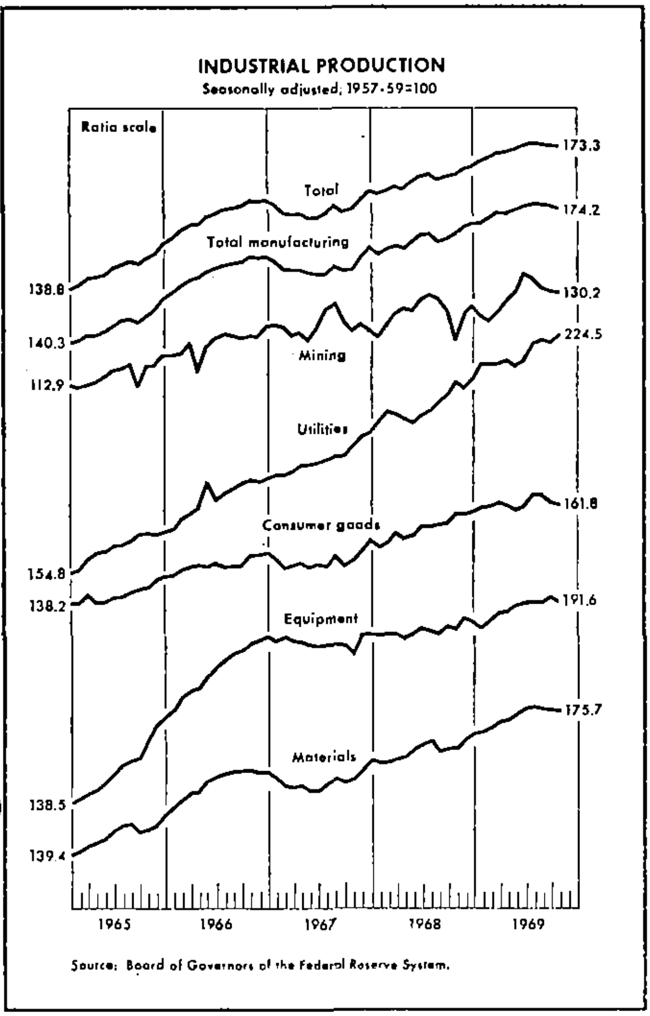
The business statistics indicate that some further slowing of the economy's rate of growth is under way, but on a longer view expansionary forces seem still dominant. The consumer appears to have become cautious about the economic outlook: retail buying has been sluggish for some time now, and recent surveys of spending plans have found further evidence of consumer restraint. Inventories at retail have risen relative to sales, and production of consumer goods—particularly of automobiles—appears to be in the process of adjustment. Partly for this reason, industrial production has declined moderately over the past three months, but strikes have also played a part in reducing output. At the same time, home-building activity remains under pressure from tight conditions in the mortgage market, although the readings on new housing starts over the past few months suggest that the rate of decline may have slowed as demand for new homes and apartments has become even more intense. On the stronger side, businessmen's plant and equipment spending plans indicate that capital outlays are likely to continue rising at a fast clip—a finding that is supported both by new survey evidence and the recent strong performance of new orders for durable goods. Moreover, looking further ahead, the expiration next year of the surtax on personal income and corporate profits will add stimulus to the economy, as will the prospective large increase in social security benefits. Meanwhile, price and cost pressures are as severe as ever, and expectations of continuing inflation appear to remain an overriding element in much economic decision making, including collective wage bargaining.

PRODUCTION AND CONSTRUCTION

The volume of industrial output declined in October for the third consecutive month. The Federal Reserve Board's index of industrial production fell 0.4 percent in October to a seasonally adjusted level of 173.3 percent of the 1957-59 average (see chart). In the decade of the sixties, output has fallen three months in a row only twice—during the mini-recession in 1967 and in the 1960 recession. The August-October decline amounted to only 0.7 percent, however, much milder than the downward movement in either 1960 or 1967. Furthermore, the recent drop has been partially the result of strikes.

Consumer goods production in October was off ½ percent from September and more than 1½ percent from July. Scattered strikes in the automobile industry contributed to this decline, but auto production schedules for the fourth quarter—originally set below 1968 actual levels—have been cut back further. On a unit basis, output of new cars fell from a seasonally adjusted annual rate of 8.7 million in September to 8.4 million in October, and in November were off an additional 10½ percent to 7.5 million units. Production of other consumer goods also eased in October. After rising in September, output of business equipment remained strong despite the General Electric strike. The overall materials index was about unchanged, and the iron and steel component was also steady at the September level. Following a very strong first half, iron and steel output has moved down from its June peak. Industry spokesmen, however, continue to predict strength through the end of the year, and data on steel ingot production indicate that output rose slightly in November.

Total construction activity continues at a high level, with private nonresidential building providing much of the strength. Residential construction spending moved higher in September and October, after declining steadily in the preceding four months. However, home building remains under pressure from very tight mortgage market conditions. During the third quarter, private nonfarm housing starts averaged 1.4 million units at an annual rate, down from 1.7 million in the first quarter, and the starts rate fell further in October to 1.3 million units. Moreover, steady declines in the number of building permits issued by local authorities suggest continued weakness in home-building over the near term. Permits volume has trend



INDUSTRIAL PRODUCTION
Seasonally adjusted; 1957-59=100

Source: Board of Governors of the Federal Reserve System.

down each month since April, and in October the number of permits issued was the lowest since early 1967.

INVENTORIES, ORDERS, AND CAPITAL SPENDING

Total business inventories[1] rose $1.0 billion in September from an upward revised August level, with retail and manufacturing inventories each increasing $480 million. For the retail sector, this was the fourth successive month of large accumulation averaging $445 million per month. Both durable and nondurable retail stores built up their stocks in September, with virtually all the increase at durables stores due to higher inventories held by auto dealers. Since retail sales have been sluggish overall, the large inventory accumulation recently has been reflected in an appreciably higher inventory-sales ratio than was the case earlier in the year. At the manufacturing level, on the other hand, a substantial jump in shipments in September, particularly of durable goods, caused the inventory-sales ratio to fall despite the rapid increase of inventories. As a result, the ratio for all businesses was about unchanged in September and remained well within the range prevailing over the past year or two. The October data for manufacturing indicate that inventory building in the sector was again very large, but shipments also gained and the inventory-sales ratio rose only slightly.

New orders received by manufacturers of durable goods continued strong through October. During the third quarter, incoming orders averaged $31.2 billion per month, up $1.2 billion from the April-June period. In September, volume advanced sharply to a record $32.1 billion as machinery and equipment buying surged. As was to be expected, new durables orders dropped a bit in October following the strong September performance, but at $31.8 billion they remained above the third-quarter average.

Business capital spending plans for 1970 point to further substantial growth, but also suggest that price inflation may absorb much of the planned increase in outlays. The fall survey by McGraw-Hill found that businessmen plan to spend 8 percent more on plant and equipment in 1970 than in 1969. Furthermore, a very recent survey conducted by the Department of Commerce and the Securities and Exchange Commission presents an even stronger picture. The Commerce-SEC study found that businessmen plan a 13½ percent spending increase (at an annual rate) between the fourth quarter of this year and the second quarter of 1970. In the McGraw-Hill survey, however, businessmen reported that they expect prices of plant and equipment to rise 7 percent in 1970, which implies that purchases in real terms would be up considerably less than dollar spending. It should be noted in assessing the plant and equipment outlook that plans for next year are still somewhat indefinite for many businesses, and that substantial revision could occur before orders are placed and construction contracts signed. However, the several surveys conducted consecutively over the past few months clearly indicate that businessmen have been upping their estimates of 1970 spending as the year draws closer. Growing fears of sharply higher capital goods prices, giving rise to a "buy

[1] The Department of Commerce has revised upward its third-quarter estimate of gross national product (GNP) by $0.5 billion to $942.8 billion. The estimate for inventory accumulation was raised from $9.4 billion to $10.7 billion, and consumption expenditures were revised downward from $581.6 billion to $579.8 billion.

now" or "build now" attitude, may have played a role in this upgrading.

On the other hand, if internal funds for financing capital programs continue under pressure from declining profits, the extremely tight conditions now prevailing in the financial markets may take on a more critical role in influencing capital spending decisions. In this connection, after-tax corporate profits turned in a second consecutive decline in the third quarter to a seasonally adjusted annual rate of $50.0 billion, the lowest level in a year.

EMPLOYMENT, PERSONAL INCOME AND RETAIL SALES

In the labor market, signs of a slight easing have remained numerous, even though the unemployment rate fell back sharply in November after several months of increase. From June to November, nonagricultural payroll employment rose only 64,000 per month, compared with the exceptionally large average gains of 238,000 in the first half of the year. While the services and trade sectors registered sizable increases in jobs, construction payrolls in November remained at June levels and manufacturing payrolls were below June levels. Sluggishness in manufacturing was further evidenced in October and November by a large seasonally adjusted decline of 0.3 hour in the average workweek of factory workers. Data from the household survey of employment and the labor force also point to some letup in the very tight conditions in the labor market that have prevailed over the last year. The labor force increased by fully 1 million persons from June to October on a seasonally adjusted basis, a rate about half again faster than that of the first half of the year. During the same period there was a 0.4 million increase in the number of unemployed, bringing the total count of unemployed to 3.2 million. Thus, in October, 3.9 percent of the labor force was unemployed, down 0.1 percentage point from September but still significantly higher than the 3.4 percent averaged in the first half of this year. The sharp November decline in the aggregate rate to 3½ percent resulted largely from a fall in the labor force, as employment increased only moderately. The movement was centered in the adult women category, where the unemployment rate fell 0.5 percentage point to 3.5 percent, equaling the low for the year. The rate for adult men also dropped to 2.2 percent from 2.4 percent but still far exceeded the previous low of 1.8 percent set last December.

Personal income moved up slowly in October, increasing by only $2.4 billion, the smallest monthly rise in over a year. Despite an upward revision in the September estimate, the September and October gains in wages and salaries were substantially smaller than those earlier this year. Had it not been for the midyear Federal pay increase, the July change would also have been quite modest. October's small $1.6 billion rise in wages and salaries reflected, in part, the decline in the average workweek in manufacturing.

Consumer demand continues to show little buoyancy. In October, according to the revised estimate, retail sales increased to a new record level of $29.6 billion but were still only about ½ percent above the previous peak reached last April. Moreover, the 4½ percent dollar gain in retail sales since last December has probably been associated with unchanged volume in real terms, since consumer goods prices have risen at about the same pace. Weakness is particularly apparent in the durables sales figures, which are below the levels of early this year. Sales of domestically produced new automobiles rose to an annual rate of 9 million units in September, but then fell back in October and November to less than 8½ million units, in line with the slow pace of the months prior to September. Sales of other consumer durables have edged down further since July, when there was a large drop.

WAGES AND PRICES

The price situation remains critical. Steep advances continue at wholesale and consumer levels, and wage pressures appear to be intensifying at a time when productivity growth is lagging.

During the third quarter, labor compensation per manhour in manufacturing rose at a seasonally adjusted annual rate of 6.3 percent, well in excess of the 1½ percent annual rate of productivity increase in the quarter. These widely divergent trends resulted in a 5 percent growth in the labor cost per unit of output, on an annual rate basis, compared with 3 percent in the second quarter. Moreover, negotiated wage settlements point to mounting cost pressures. In the first nine months of 1969 the median negotiated settlement provided for a 7.4 percent per year gain in wages and fringe benefits over the life of the contract. This is well above the median increase of 6.0 percent per year negotiated in 1968 and more than twice as great as the median provided by 1965 contracts. Negotiated settlements were larger in nonmanufacturing than in manufacturing, with construction workers receiving particularly sizable boosts in wages. The labor contracts of recent years typically have provided for bigger pay raises in the first year of the contract than later, and this trend appears to be continuing. Thus, while the average annual increase in wages (excluding fringe benefits) under agre ments signed this year is 6.6 percent over the life of the contract, the median increase in the first year is a full 8.0 percent. Cost-of-living escalator clauses may, of course, add to the scheduled raises beyond the first year of many contracts.

Wholesale prices of industrial commodities continue under severe pressure. The index of industrial goods prices advanced at a sharp 6.4 percent annual rate in October. A particularly steep price increase in transportation equipment resulted from the higher prices on 1970-model cars, which took effect that month. In November, industrial prices moved up further at a 4.2 percent annual rate, according to the revised estimate. Thus, the average annual rate of rise during the first two months of the fourth quarter was 5.3 percent, compared with a 3½ percent annual rate in the third quarter.

Consumer prices continue to climb at excessively high rates, although there has been some slight moderation since the first half of the year. From June through October, the average annual rate of increase of the consumer price index was 5.2 percent, compared with 6.3 percent in the first six months of 1969. In October, prices rose at an annual rate of 4.6 percent as food prices fell for the first time in eight months, a largely seasonal phenomenon. Excluding the food component, prices moved up at a 7.4 percent rate. A major factor in the October rise was the price increase on domestically produced 1970-model cars.