The Business Situation

Though obscured somewhat by the effects of the General Motors strike, recent business indicators suggest continued sluggishness in most sectors of the economy. In November, industrial production declined, personal income posted only a small increase, and retail sales continued to put on a lackluster performance. Continuing the trends which began in earlier months, businesses accumulated inventories at a relatively rapid pace while their sales generally fell; as a result, some areas of the economy —particularly the wholesale and manufacturing sectors— have a surfeit of inventory stocks. Although the automotive strike was partly responsible, the slackening in the economy seems to go beyond the direct and indirect effects of the work stoppage. In sharp contrast to much of the rest of the economy, residential construction activity has continued to gain upward momentum. With the resumption of production at GM, the stepped-up activity in the automobile and related industries should provide a substantial impetus to production and employment in the months immediately ahead.

Despite the pervasive slack within the economy, consumer prices have continued their steep ascent. There has been some moderation in the rate of advance of the overall consumer price index as a result of a marked slowing in the pace of food price increases. However, this development has obscured somewhat the extremely rapid rise in prices of nonfood consumer commodities and consumer services. At the same time, the rate of advance of wholesale industrial prices does appear to have moderated somewhat during 1970, affording some encouragement that prices of consumer nonfood commodities may soon respond similarly. Thus far, however, there have not been any clear signs of abatement in the rate of consumer price increases.

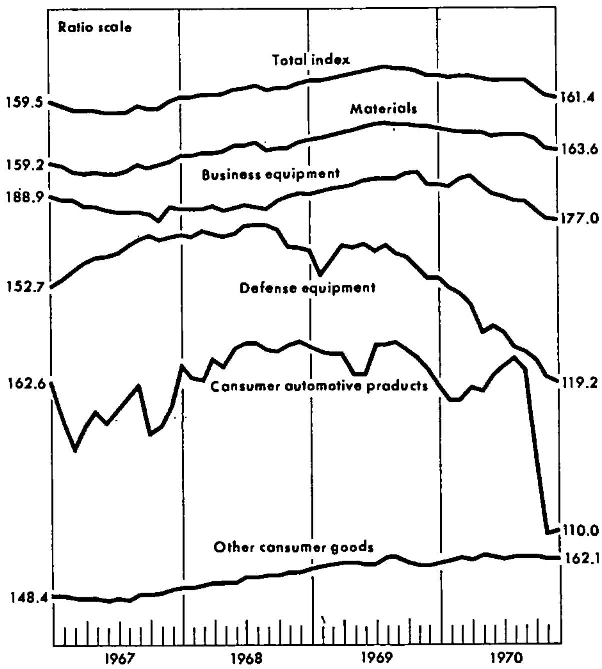
PRODUCTION, ORDERS, AND INVENTORIES

Industrial production continued its downtrend in November, contracting by 0.6 percent on a seasonally adjusted basis (see Chart I). Unlike the preceding two months when the fall in production was partially attributable to the strike at GM, the indirect effects of this work stoppage appear to have added little downward impetus to the overall index. The November drop centered in the business and defense equipment and the materials components. At its November level of 161.4 percent of the 1957-59 base, the Federal Reserve Board's index of industrial production was 7.6 percent below the peak attained in July 1969. Thus, measured in terms of this index, the current business slowdown is comparable in magnitude to the 7.3 percent fall during the 1960-61 contraction but is considerably milder than the 14 percent decline recorded in the 1957-58 recession. With the resumption of production at GM in late November, the index will probably show considerable gains in the near term as the effects of the ten-week strike unwind themselves.

Output of consumer goods was virtually unchanged despite the fact that the production of automobiles actually edged upward. Consumer goods output exclusive of automobiles was sluggish throughout the year; for the first eleven months of 1970 the index has risen by only 0.9 percent. Moreover, among selected consumer goods categories, such as furniture and apparel, output actually decreased in 1970. The November declines in defense and business equipment output were further extensions of downward trends which have been under way for some time. Defense goods production has been on the downslide since August 1968, while business equipment production has declined 11.9 percent from the October 1969 peak.

Following three consecutive—and at least partly strike-related—monthly declines, new orders for durable goods advanced by 1.9 percent in November on a seasonally adjusted basis. However, at $29.0 billion, orders in November were still 5.2 percent below the monthly average in 1969. The principal factors underlying the November increase in durables orders were the sharp spurts in orders for nonautomotive consumer durables and producers' capital goods. Having jumped 5.8 percent to $6.9 billion, orders for producers' capital goods reached the highest level since September 1969. Capital goods orders appear to have strengthened somewhat in the last three months, although the monthly average for the first eleven months of 1970 was still below the average for 1969. In view of the general lack of growth in planned plant and

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. Data for latest four months are subject to revision.
Source: Board of Governors of the Federal Reserve System.

equipment expenditures projected by recent surveys, it is uncertain whether this uptrend in orders is indicative of some future strengthening in investment spending. While orders for durables increased in November, durables shipments continued to edge down to the lowest level since December 1968, marking the fourth successive monthly decline.

There apparently continue to be some areas in the economy where inventory stocks are a bit high relative to the volume of sales, though the extent of the imbalances has been clouded by the automotive strike. Large accumulations of inventories in October at wholesale outlets, retail stores, and manufacturing firms more than offset a $1.0 billion contraction of retail automobile dealers' stocks, so that total business inventories rose by only a small amount. Within the trade category, the inventory-sales ratio for nonautomotive retailers actually dipped slightly. At wholesale outlets, however, accumulations of stocks continued to outrun sales, and the inventory-sales ratio rose to its highest level in a decade. Manufacturers' inventories swelled by $0.8 billion in October, more than double the average increase in earlier months of 1970. This inventory accumulation coupled with a $1.5 billion fall in sales pushed up the inventory-sales ratio, with the imbalance problem concentrated in the durables sector. Because much of the October decline in durables sales was strike-related, it appears that the inventory-sales ratio for durables manufacturing somewhat overstates the extent of any inventory-imbalance problem in this sector. However, November data—which are available for manufacturing only—indicate that the problem of excess stocks in the manufacturing sector was exacerbated in that month. Durables manufacturers accumulated another $0.4 billion of inventories in November, while their sales dropped by $0.6 billion. Unlike that in the previous month, the November fall in sales was widely distributed and was not primarily associated with the automotive strike. Indeed, even the large decline in the sales of transportation equipment was accounted for by reductions in the shipments of the aerospace industry.

RESIDENTIAL AND NONRESIDENTIAL CONSTRUCTION ACTIVITY

After having bottomed out in the first quarter, residential construction activity has progressively strengthened throughout the third quarter. This trend continued in November when total private housing starts expanded by 122,000 units to a seasonally adjusted annual rate of about 1.7 million units. This represented the largest number of starts initiated in any one month since January 1969 and exceeded the average number of starts recorded in the first quarter of 1970 by 35 percent. About 60 percent of the November surge in starts occurred in the multifamily category. However, starts of single-family structures, which typically have a higher value per unit, also rose by about 50,000 in November to the highest level since December 1968. Because construction activity is spread out for several months after new units are begun, residential housing expenditures tend to lag the series on housing starts. Thus, following the trend in housing starts, outlays for nonfarm residential buildings have also accelerated sharply in recent months. Since June, when outlays fell to a recent low of $28.1 billion on a seasonally adjusted annual rate basis, spending on housing has expanded at an annual rate of 20.4 percent through November. Moreover, the November surge in starts would suggest some further gains in outlays in the months immediately ahead. In a similar vein, the recent strength in building permits also suggests some further strength in this sector. Marking the fourth consecutive monthly increase, new permits advanced slightly in November to a record high 126.0 percent of the 1957-59 base.

Residential construction activity continues to be favorably influenced by the large deposit flows to the nation's mutual savings banks and savings and loan associations, the major suppliers of mortgage credit. While these flows have, of course, expanded the availability of mortgage credit, there is some evidence that the increased supply of funds is beginning to produce some easing in the terms under which mortgages are granted. Mortgage interest rates, which tend to be quite sticky, have edged down slightly. Between July and October, the interest rate on thirty-year Federal Housing Administration mortgages fell by 14 basis points and that on conventional mortgages declined by 10 basis points. The latest data show an increase in the loan-price ratio for conventional mortgages on new homes, suggesting a reduction in downpayment requirements. This easing in mortgage market conditions bodes well for an extension of the strength in residential construction activity into 1971.

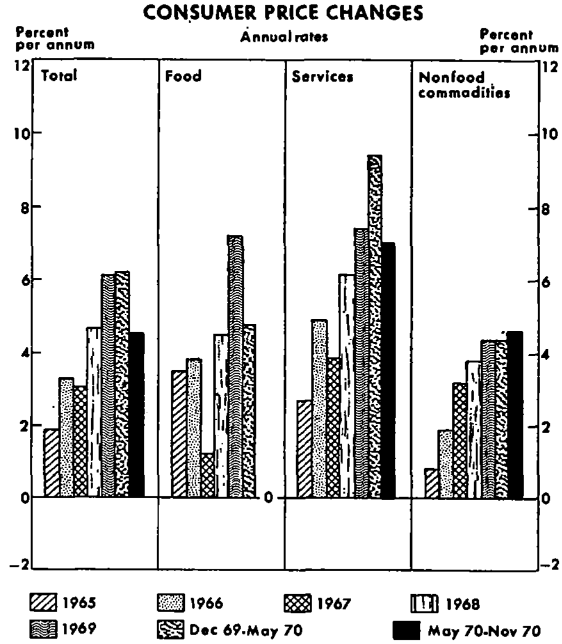
While construction activity in the residential sector has gained upward momentum throughout most of 1970, the opposite trend has emerged in the private nonresidential construction sector. Indeed, for the three months ended in November, the value of new commercial and industrial construction put in place was 10.6 percent below the first-quarter annual rate average of $17.6 billion. Similarly, the F. W. Dodge data on construction contract awards for commercial and industrial structures have been characterized by a distinct downward trend in 1970, and spending on nonresidential structures as measured in the gross national product (GNP) accounts showed absolute declines in both the second and third quarters of 1970. The weakness of new construction activity in the industrial and commercial sector is, of course, in line with the paring-down in business planned capital spending which has characterized 1970. In real terms, outlays on structures have fallen off more sharply than have outlays on producers' capital equipment. This suggests that business firms have attempted to economize on their investment costs by expanding and modernizing productive facilities within existing structures.

PRICE DEVELOPMENTS

Inflation continues to be a more deeply rooted problem than most observers had originally thought; despite the slowdown in economic activity, the pace of inflation does not appear to have noticeably abated. In November, the consumer price index advanced at a seasonally adjusted annual rate of 3.7 percent, down considerably from the 6.4 percent average increase of the preceding two months. In view of the seesaw monthly movements in the rates of change in this index throughout the year, it is too soon to hail November's slowdown as the beginning of a downtrend. Moreover, part of the improvement in November was the result of the decline in food prices, whereas the rise in nonfood commodities prices actually exceeded the average gain in these prices for the first half of 1970.

During the past two years, the price rises originating in various sectors have contributed disproportionately to the gains in the overall consumer price index (see Chart II). While in 1969 rising food prices pulled up the overall index, they have tended to dampen the advances in the consumer price index during 1970, particularly in the closing months of the year. On the other hand, nonfood commodities prices continue to surge ahead. Adjusted for seasonal variation, these prices increased 4.8 percent in November, following rises of 6.8 percent in October and 6.8 percent in September. As shown in Chart II, there has been no abatement in the rate at which nonfood

Chart II
CONSUMER PRICE CHANGES



Note: Seasonally adjusted except for services.
Source: United States Department of Labor, Bureau of Labor Statistics.

commodities prices have been advancing. The failure of these prices to respond to the economic slowdown is one of the most perplexing aspects of the present inflation. Similarly, services prices accelerated in November, growing at a rate of 7.6 percent. (Services include such things as medical care, various modes of public transportation, and insurance.) Price rises in this sector have been the primary source of increases in the consumer price index. Though constituting only about one fourth of the overall index, services prices have contributed a shade more than half the past year's rise. Like those for nonfood commodities, these price rises have also stubbornly persisted.

There has lately been some easing in the rate at which wholesale industrial prices have been advancing. In December, according to preliminary seasonally adjusted estimates, these prices rose at an annual rate of 2.8 percent, reflecting primarily the higher prices of fuels and electrical power. During the second half of 1970, industrial wholesale prices posted a 3.2 percent annual rate gain, compared with the 3.8 percent growth in the first half of 1970 and the 4.2 percent growth in the second half of 1969. It may be that the failure of consumer commodities prices to reflect the slowing in the pace of wholesale industrial prices is in part a consequence of the rapidly rising shipping costs. Wholesale agricultural prices fell 7.2 percent on a seasonally adjusted annual rate basis in December, marking the third successive monthly decline. This decline entirely offset the advance in industrial commodities prices so that the seasonally adjusted overall wholesale price index was unchanged in December.

PERSONAL INCOME AND CONSUMER DEMAND

Personal income posted a relatively small increase of $2.4 billion in November, less than half the average monthly increase registered in 1969. This gain was depressed somewhat by a roughly $1 billion nonrecurring payment to retired railroad workers in October, which had buoyed the level of personal income in that month, while the removal of the retroactive payment from the November data depressed the level of personal income in that month. Even allowing for this factor, however, the rise in personal income in November was of a relatively small magnitude. The growth in personal income principally reflected a $1.8 billion gain in wage and salary disbursements; in turn, this increase in disbursements centered in the government and services sectors which posted expansions in payroll employment in November. In the manufacturing sector, wage and salary disbursements declined slightly, mirroring the November contractions in overtime hours and employment.

According to preliminary estimates, there was a small decline during November in durables retail sales which more than offset the gain in nondurables sales, so that total retail sales on a seasonally adjusted basis edged down 0.5 percent. While consumer spending has been sluggish all year, the purchases of durable goods have been particularly lethargic. Dealer sales of domestically produced new cars during the first eight months of the year were off 8.2 percent from the corresponding average for the last year; during the September-November period when the GM strike was in effect, dealer sales of new cars produced by the other automotive companies contracted further on a seasonally adjusted basis. In addition, retail sales of nonautomotive durables have failed to register any growth during the year; for the first ten months, nonautomotive durables sales in current dollars were virtually unchanged relative to the same period in 1969. Concurrent with the sluggishness in retail sales—and in consumer demand generally—have been large increases in disposable income, which is equal roughly to personal income less personal taxes. As a result, then, the personal savings rate has been abnormally high all year. The large store of savings accumulated in recent quarters may provide the fuel for future step-up in the pace of consumer spending, though its timing and magnitude are still uncertain.