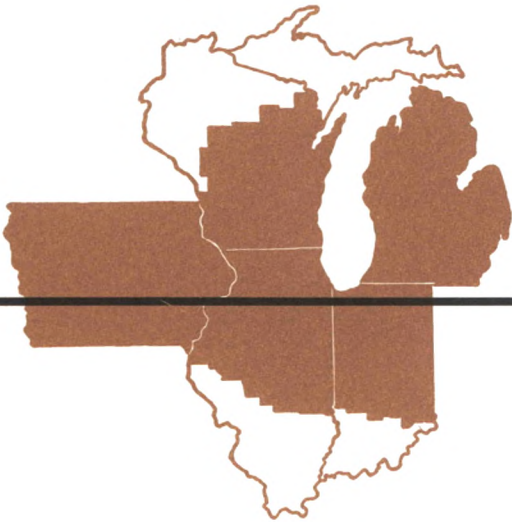


A review by the **Federal Reserve Bank of Chicago**

Business Conditions

1961 November



Contents

Spotlight on prices 2

The Trend of Business 14-16

spotlight on **Prices**

During the postwar period as the American economy has approached high levels of employment and output, prices have shown an annoying tendency to rise. In this connection, the Chairman of the President's Council of Economic Advisers said recently: "The test next year will be whether the surge of recovery will continue toward full employment or whether a revival of creeping inflation will hamper our efforts to use the full potential of the economy"

But there are differences of opinion on almost every aspect of the problem, ranging from whether the price indexes accurately measure the trend of prices to the importance of stable prices as a goal of economic policy. In this issue of *Business Conditions* several, but by no means all, of the ramifications of the problem are discussed.

First and foremost, of course, must be consideration of **the role of prices in a market economy**. It is important that prices be free to change in response to new technology, shifts in consumer income and tastes and other market forces if they are to serve as effective guides for economic activity. (See pages 3 to 5.)

The general trend of prices has been upward during the past twenty years, and the prices at which common stocks and farm real estate are traded currently, to mention only two examples, suggest that many people expect the trend to continue. (See pages 5 to 8.)

Price trends in basic industries, however, have varied greatly during the postwar period. Metals and machinery, for example, have risen relatively more than many other products, but in recent years conditions in these industries have changed appreciably in response to increased capacity and competition. These factors could result in very different movements in the future, unless demand were to show a tremendous increase. (See pages 8 to 10.)

Prior to World War II price indexes were used largely by economic historians, but now more and more, the indexes are used as a basis for contract price adjustments in the private sector of the economy. Many collective bargaining agreements contain clauses providing for automatic wage adjustments in accordance with changes in the consumer price index. The price conditions of long-term leases and fuel and raw material supply contracts often are geared to changes in price indexes. The indexes also have come to play an important part in the formulation and evaluation of national monetary and fiscal policies as Government has assumed greater responsibility for economic trends.

It is increasingly important, therefore, that the task of **measuring prices** be performed as accurately as possible. While this might appear to be a relatively simple undertaking, a brief review of the problem indicates the complexity of the job and the divergence of opinion on how it should be done. (See pages 10 to 14.)

The role of prices in a market economy

Production and distribution of the large quantity of goods and services used by consumers is the primary job of our economy. Doing this continuously and well is no small accomplishment. It doesn't "just happen." It requires the combined efforts of a skilled, experienced work force 70 million strong, a huge stock of complex industrial facilities and an abundance of natural resources. But most important, it requires coordination and direction—something to guide production in accordance with consumer wants.

In some countries this job is done largely by a central planning board; but in the United States — as in any "enterprise system"— the guiding mechanism is primarily a network of prices established by the interplay of supply and demand forces converging in the market place.

The system in motion

The price-making mechanism usually functions so smoothly that individuals are only vaguely aware of the complex jobs it performs. Consumers go about their daily business confident that they will find supermarkets and department stores stocked with a wide variety of goods, that milk and newspapers will be delivered each morning and that they can easily locate shops where appliances and automobiles can be repaired, institutions where savings may be deposited or loans obtained and motion picture theaters and resort hotels for relaxation and entertainment. All this is made possible only because the price system has "told" producers what and how much to produce, rationed available labor and resources needed in the production process, divided output between current consumption and investment, dis-

tributed the final products among users and allocated income among those contributing to production.

The demands for goods and services are expressed in terms of the prices that consumers are willing to pay, while the prices that sellers are willing to accept reflect the costs—outlays for labor and other resources, overhead and some allowance for profit—of fulfilling these demands. The prices that emerge in the course of trading—the terms on which exchanges are made between buyers and sellers—serve to indicate relative *values*, as the market assigns them.

If consumer demand for a particular item increases owing to a change in taste or rise in income, its price tends to rise. This is a signal to sellers to increase production, if they can, and offer more for sale; it also may attract new suppliers to the industry or trade. Conversely, when the demand for a product decreases and prices fall, suppliers react by curtailing their production with the result that resources become temporarily unemployed or are channeled into more rewarding or profitable activities elsewhere. This simple process, applied to a great variety of activities and coordinated through the shifting of people and capital among various activities in response to relative price changes, is the core of the enterprise system.

Prices often "sticky" in practice

It is only by moving up or moving down relative to one another that prices succeed in communicating to those who need to know the changes that are occurring in such fundamental factors as consumer tastes, costs of production, agricultural harvests, technical methods and productive resources.

In reality, price movements often occur less frequently and are less clear-cut and distinct than might be expected, considering the volatility of consumer tastes and the many other forces that converge in markets. Sometimes, however, the observed stability of individual prices is deceptive. Sellers frequently hold fast to their list prices for extended periods, adapting to short-term variations in market conditions by offering discounts from list or adding extra charges. Under these circumstances the meaningful or "effective" price at any moment is the list price adjusted to reflect the prevailing extra charges or discount, if any. Such prices are likely to display a good deal more movement with the passage of time than list prices.

Another factor tending to make prices look more rigid than they are is the practice followed in some trades and industries of varying the size or composition of the package as an alternative to changing price. Sometimes this reflects the reluctance to depart from a long-established and convenient price. Confectionery manufacturers on occasion have preferred to adjust the weights of candy bars rather than deviate from traditional 5 or 10 cent retail prices when changes have taken place in the price of the basic ingredients—cocoa, sugar, etc. Altering the size of an article while adhering to a constant market price is essentially the same thing as changing the price.

Sellers may also attempt to side-step outright price competition, preferring to engage their rivals on other grounds. Slight variations in product design, color or performance characteristics frequently are used as competitive techniques. Promotional methods—such as credit terms, product packaging and advertising—and performance on delivery and other services may also be considered more "congenial" competitive instruments.

The degree of competition, which varies greatly among industries, also has an important bearing on price behavior. A single firm may account for so large a share of total industry sales that small competitors will follow its lead in pricing. However, price leadership and the closely related phenomenon of administered prices—the posting and evident adherence to a specified price or schedule of prices—both are essentially inconsistent with the optimum functioning of competition and market-determined prices as the predominant guide to economic activity.

In some sectors of our economy prices are determined by direct controls. These often accompany the granting of an exclusive operating franchise such as for the sale of electric power, gas, water or telephone service. Since competition cannot serve as an effective regulator of these prices, public boards are substituted to assure that prices are reasonable. On the other hand, various economic groups frequently seek the support of Government in blunting the impact of market competition in order to maintain desired prices. Examples of this include protective tariffs and import quotas, farm price support programs, fair trade practices legislation, minimum wage laws and various Government-sponsored programs designed to make credit more available or less costly to certain groups of borrowers.

The price structure in the United States, thus, includes many types of prices—some are determined in auction markets where changes occur almost constantly, some are established by private firms subject to approval by public boards or commissions, some are established or supported by Government and many others are set by "custom" or by negotiation. While competition is not the direct and obvious controlling force in all sectors, competitive market prices con-

tinue to be the central nervous system of the American economy. Measures which hamper its performance should be viewed

critically, at least until effective substitute means of doing the jobs now done by market prices are clearly apparent.

The general trend of prices

During the last two decades consumer and wholesale prices in this country have more than doubled. Most of the increase, however, occurred during two periods—1941-48 and 1950-51. Aside from these “war years” the indexes of wholesale and consumer prices published by the U. S. Bureau of Labor Statistics were relatively stable but nevertheless rose on balance. Even during periods of recession (with the exception of 1949) the indexes showed little or no decline. This caused many people to conclude that there is an inflation bias in the American economy—that periods of rising prices are likely to occur periodically and that these probably would not be offset by subsequent declines.

It is readily apparent that mobilization for war places tremendous demands on any nation and is likely to bring strong upward pressure on prices. From 1941 to 1945 nearly one-third of the United States total production was directed to winning the war. From the end of 1940 to the end of 1943 consumer and wholesale prices increased 23 per cent and 29 per cent, respectively. Thereafter, as general price and wage controls and the supporting ration and allocation programs became effective, prices remained fairly stable until mid-1946, by which time most of the controls were removed.

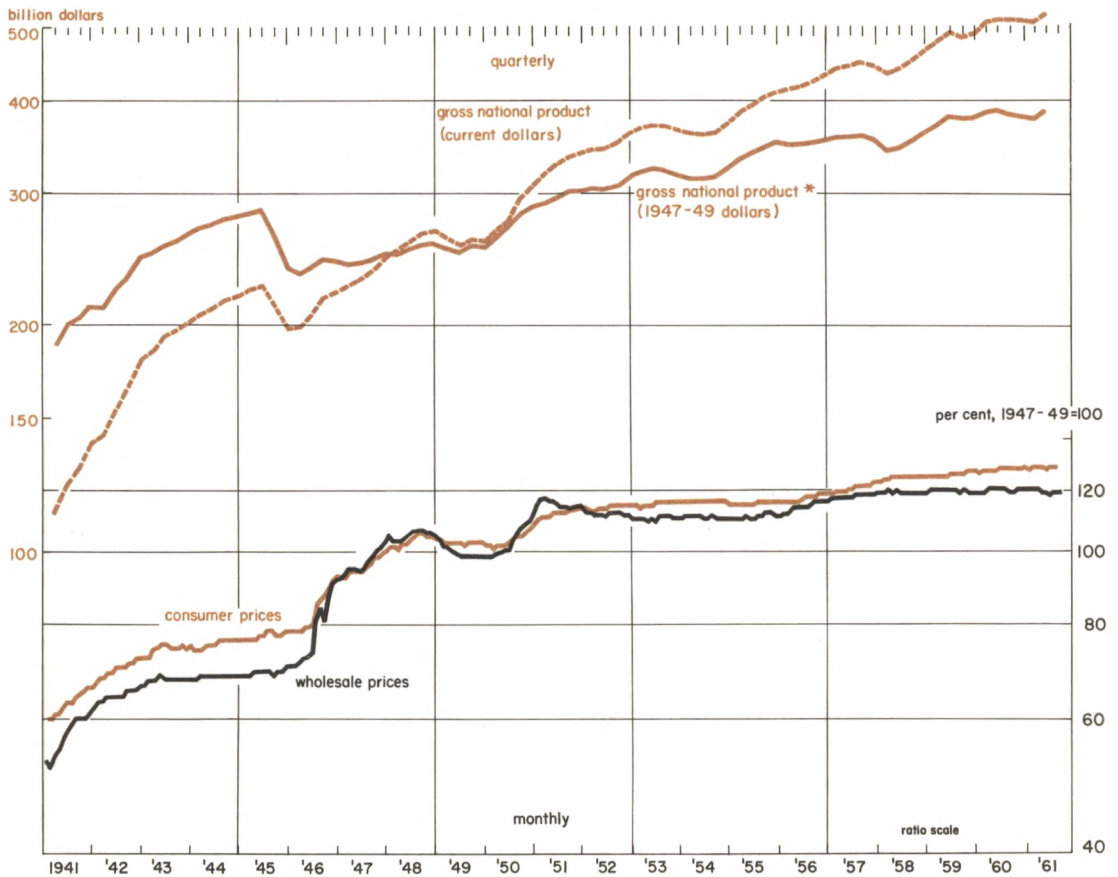
When the war ended, consumers and business firms had large holdings of cash and other liquid assets, their debts were at low levels and credit was readily available at comparatively low interest rates. Commodi-

ties which had largely disappeared from markets during the war were rapidly becoming available again. But the enormous backlogs of demand for many kinds of goods were far in excess of available supplies at the wartime price level. The surge of buying caused prices to mount rapidly. Between mid-1946 and the end of 1948 the consumer and wholesale price indexes increased 31 per cent and 42 per cent, respectively.

In 1949, a recession year, the consumer price index (CPI) declined 2 per cent and the wholesale price index (WPI) dropped 6 per cent. During the first part of 1950, as the business recovery got under way, both indexes registered modest gains and then surged ahead sharply following the outbreak of fighting in Korea in late June. The consumer price index rose 8 per cent between June 1950 and February 1951 and the wholesale index about twice that amount. The increases for a number of commodities during this period were phenomenal. Among these were crude rubber, for which the spot price was up 138 per cent; wool tops, 94; and tin, 135. About this time “emergency” price and wage controls were invoked and maintained until 1953.

During the remainder of 1951 and all of 1952 wholesale prices slowly retreated from their Korean-induced peaks, while consumer prices continued to rise but at a greatly reduced pace. Prices, on balance, remained fairly stable from 1953 to 1955; but the next two years saw a steady upswing in both in-

Although gross national product has risen over 300 per cent since 1941, when the effects of price increases are removed, the rise is limited to only 90 per cent



*Adjusted to remove effects of price changes.

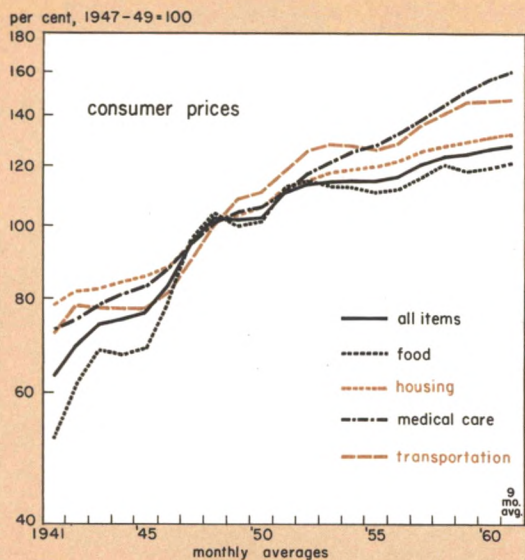
dexes as the economy operated at a high level, with plant capacity and labor rather fully utilized. Since mid-1958 the WPI has remained virtually unchanged, while the CPI has continued to rise although at a slower rate than in 1956 and 1957.

The rise in the price indexes in 1956 and 1957, when the economy was operating near

capacity, was taken as conclusive evidence by many that any period of relatively full employment and rapid expansion would probably also be a period of increasing prices. Higher levels of demand, employment and business profits were said to make it possible for workers to demand, and obtain, large

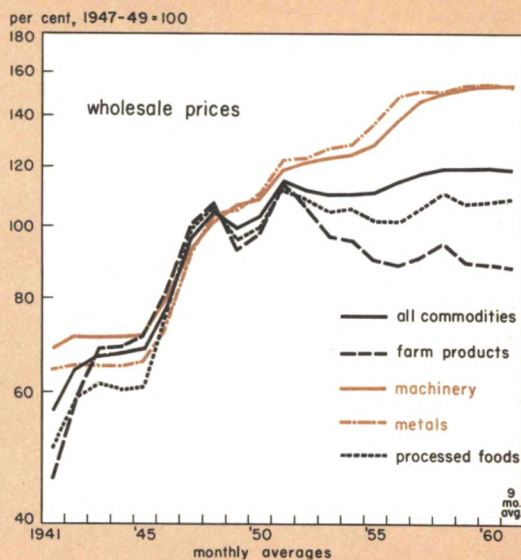
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Price trends in the past two decades



In the consumer sector, food prices, followed by medical care, have recorded the greatest relative increases during the last two decades. In recent years, however, the advance in food prices has been less than for other consumer prices, while the price of medical care has continued to rise vigorously. To a certain extent this has reflected the introduction of new drugs and equipment which have greatly improved the effectiveness of medical science.

Housing, including rent, has registered the smallest relative increase since 1940. The imposition of rent controls during World War II and the early postwar period tended to retard the rise in housing, but since the removal of controls in most areas by the late 1940's, housing costs have kept pace with the increase in other consumer prices.



In the wholesale sector, prices for farm products, machinery and metals have recorded the greatest relative increases during the last two decades. Much of the increase in food prices was related to the enormous demands of World War II and the early postwar period. Although farm product prices have declined since 1951, processed food prices have continued to rise in line with higher processing and distribution costs.

Most of the advance in prices for metals and machinery has come since 1945, following the removal of World War II price controls. These increases were largely attributable to the heavy demand pressures of the postwar period. Since 1958, however, further price advances in these industries have been held in check by the presence of excess capacity and intense competition.

continued from page 6

wage increases. The rising demand also made it possible for manufacturers to pass along their increased costs in the form of higher prices.

Once established, the higher levels of prices and wages tended to be maintained in succeeding periods of slower growth or decline in demand. Indeed, wholesale prices have remained fairly stable during the last three years despite the presence of substantial unused capacity in many basic industries

and relatively high unemployment.

In these circumstances it has been suggested that public policy could prevent inflation only by limiting the growth of demand and maintaining considerable amounts of unused plant and unemployed labor. Otherwise some degree of "creeping" inflation very likely would be the price of full employment and rapid economic expansion. If inflation were to be avoided, it might be necessary to make basic changes in the price-making mechanism.

Price trends in basic industries

By October 1961, eight months after the low point in business activity, industrial production had risen 8 per cent to a record high. During this period average nonfarm wholesale prices declined slightly.

What are the prospects for continued price stability if the upsurge in output and sales widely predicted for the next six to nine months does in fact occur? After the recession lows in 1949 and 1954, an appreciable rise in prices did not develop until a full year had elapsed. In the current situation one vital factor certainly will be working to restrain price increases—the existence of relatively more unused capacity in basic industries and in the labor force than in earlier postwar periods of high and rising demand.

From 1947 to 1957, except for recession periods, output in most manufacturing industries pressed close against capacity reflecting the high level of demand of the postwar period. At the end of 1955, for example, total manufacturing output was estimated to equal nearly 92 per cent of capacity. The steel and electrical machinery industries at that time were operating at 98 per cent of

capacity; nonferrous metals and motor vehicles, 95; machinery, 87; and most non-durable goods at 90 per cent or more. (Estimates are from McGraw-Hill.)

Nonfarm wholesale prices advanced 32 per cent during this period, as can be seen in the accompanying chart, while steel, non-ferrous metals and machinery and equipment registered substantially greater gains. In the latter part of 1955 upward price pressures were further intensified by a capital expenditure boom, primarily geared to expansion of manufacturing capacity. From the low point in 1954 to the peak in 1957 manufacturers' outlays on new plant and equipment rose from an annual rate of 11 billion dollars to 16 billion, a level which has not been equaled since that time. The lion's share of this increase was accounted for by the steel, aluminum, cement, automobile and machinery industries which had experienced difficulty in meeting peak demands of consumers even when operating at capacity prior to 1957.

This round of expansion, which eliminated many shortages and bottlenecks, plus a slowing in the rate of over-all economic growth,

has helped materially to alleviate upward price pressures in the wholesale sector in recent years. Reflecting this, from 1957 to the present, nonfarm wholesale prices have risen only 1 per cent. In particular, steel has increased 4.5 per cent (all of this occurring in 1958) compared with a rise of about 100 per cent from 1947 to 1957. In the non-durable goods sector, petroleum prices are down 8 per cent from their average in 1957 while chemicals are about unchanged.

Still more capacity

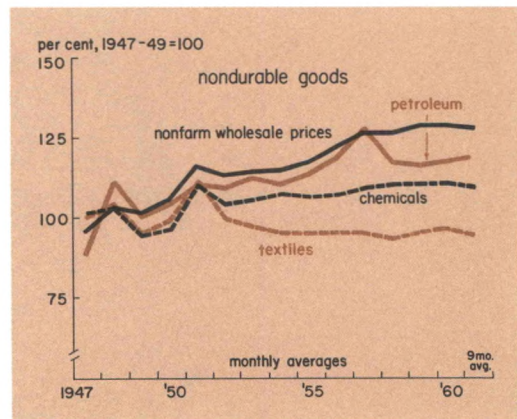
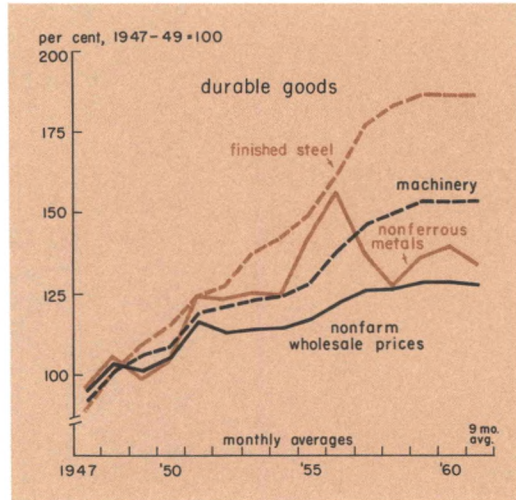
Despite the attainment of record levels of aggregate activity in recent months, many basic industries continue to operate at levels well below capacity. Steel has been operating at about 70 per cent of capacity; nonferrous metals, motor vehicles and machinery, around 75 per cent; and most nondurable lines, with the exception of paper, at rates well below those of a few years ago.

In this environment competition has mounted as various industries have tried to expand production. Steel, aluminum, glass and plastics, for example, are pitted against one another in trying to capture a greater share of the container market. In the construction industry reinforced concrete is making inroads against structural steel, and aluminum and plastics are replacing such conventional materials as wood and asphalt products.

The foregoing, plus vigorous competition from foreign suppliers both in domestic and overseas markets, has made it difficult for some manufacturers to post price increases to offset higher wage and other operating costs and, in some instances, price concessions have been necessary to retain long-standing customers.

Meanwhile, business expenditures for new plant and equipment, which declined only

Rise in industrial wholesale prices has leveled off in recent years



moderately in late 1960 and early 1961, are increasing again. About 70 per cent of capital outlays are being made for replacement and modernization rather than expansion; but clearly all expenditures on new capital goods, whether for expansion or mod-

ernization, have a bearing on future price trends. New facilities almost invariably are more efficient than those currently in use, thereby affording more room for future cost reductions and strengthening of competitive positions.

Against the current background of ample manufacturing capacity and continued emphasis on achieving more efficient production, American business firms may be able to supply the demands of a prosperous economy in 1962 without the undesirable accompaniment of a build-up of inflationary pressures. In this connection it is interesting to note that there have been periods in our

history, lasting for as long as a decade, during which production rose vigorously without any appreciable rise in prices. During the 1920's, for example, industrial production increased by nearly one-half while consumer and wholesale prices, after declining sharply in 1920-21, remained relatively unchanged through the remainder of the decade. It is conceivable that with the postwar surge of demand behind us, a faster growth of the labor force in prospect, significant margins of unused capacity in most basic industries and technology advancing rapidly a basic shift in the underlying supply-demand situation is at hand.

Measuring prices

"No country has better price statistics than the United States, but improvements are still needed." This was the general conclusion reached recently by a Congressional subcommittee, following extensive hearings on a review of the Government's major price indexes. The review had been prepared by a group of economists and statisticians appointed by a private research agency—the National Bureau of Economic Research—under contract with the Bureau of the Budget.¹

The objective is simple

While the purpose of a price index—to indicate the rate at which prices are rising or falling—is simple enough, preparing an index which does the job accurately is quite another matter. Existing goods and services

¹Hearings before the Subcommittee on Economic Statistics of the Joint Economic Committee, Part 1, January 24, 1961; Part 2, May 1, 2, 3, 4 and 5, 1961; Report of the Subcommittee on Economic Statistics, July 21, 1961.

are constantly modified in one way or another to maintain or expand market demand for them. There is also a continuous flow of new products, some of which (synthetic fibers, television and tranquillizers, for example) succeed in obtaining substantial markets. As consumer expenditures for new items increase, other products may become obsolete and gradually disappear. It is this ever-changing form and mix of goods and services that makes it difficult to measure price changes.

The job is complex

It is relatively simple, of course, to prepare a price index for an easily identifiable commodity—corn or copper, for instance—which is traded on organized exchanges and for which the basic characteristics change only gradually, if at all. But preparing an index of prices for a large number of products, including the many which are greatly affected by rapid technological progress or

changes in consumer taste is much more complex. Should the indexes merely reflect changes in the average prices of, say, new automobiles year after year, giving no consideration to changes in horsepower, durability, "standard" equipment and other factors, or should efforts be made to adjust the price index for such changes? In other words should the indexes attempt to measure changes in prices of "real" products available in the markets year after year or changes in prices of products which are equivalent, in terms of their ability to provide service or satisfaction, to products commonly available in some earlier (base) period?

These issues, as well as the rather difficult problem of determining actual prices at which products are sold, have taxed the ingenuity of everyone who has come to grips with the problem of making price indexes. The study committee pointed out that there was widespread feeling that the indexes may have an upward bias, that is, a tendency to indicate greater price increases than had actually occurred because of failure to take full account of changes in quality.

To illustrate, since 1950 the price of medical care as recorded by the CPI has increased about 52 per cent, or roughly twice as much as the average of all consumer prices, but no allowance has been made for the remarkable

advances in preventive medicine and rapid cures. New drugs costing more in many instances can be used to treat diseases at home which a few years ago would have required extensive hospitalization. Similarly, the length of stay in the hospital for many illnesses has been greatly shortened by more efficient diagnosis and treatment. In other words, although the price of medical care has risen, the effective cost of sickness in many instances probably has fallen.

The hearings revealed, however, there was no general agreement that the indexes have had an upward bias or that it would be practicable to make adjustments for all changes in quality associated with the continuous modification of existing goods and the introduction of new products and services. The Bureau of Labor Statistics, which compiles and publishes both the consumer and wholesale price indexes, has concluded there was "little reliable evidence" to support the claim that the CPI had overstated "by some undefined amount" the rise in prices that occurred during the past decade. In part this is because there may be offsetting factors in the opposite direction, including deterioration in the quality of certain goods and services and the increased operating costs and faster obsolescence associated with new products.

In addition, the BLS reported that it had made considerable progress over the years with the help of buyers and manufacturers in excluding the effects of price changes due to quality improvements. In the case of new automobiles, for example, although the average list price of the lower-priced makes rose nearly 60 per cent between 1950 and 1960, the CPI reported an increase of only 31 per cent. This was because of adjustments for extra attachments and identifiable quality improvements such as the introduction of

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more powerful engines and automatic transmissions.

The study committee also concluded that a possible upward bias of the index could result if new products were introduced into the index "too late" and old ones retained "too long." Prices of new products are often relatively high when first placed on the market, owing to substantial research and development costs and limited production, but

decline rapidly as increased output permits economies of large-scale production and distribution. In these circumstances, an index that tended to defer inclusion of new products might have an upward bias.

While the study committee felt it would be desirable to bring new products into the indexes earlier, there was not general agreement on the urgency of this proposal. The BLS pointed out that present procedures

What is a price index?

A price index measures the change of prices over time relative to some base period. It may include one or many items and these may or may not be "weighted" in accordance with their relative importance. The average of prices during the base period is usually set equal to 100, with the averages on subsequent dates expressed as a percentage of the base.

As it usually would not be practicable to include prices of all relevant items, the making of a price index requires decisions as to what should be included, whether to weight the items and, if so, how to do it. These decisions, of course, will differ depending on the purpose the index is intended to serve.

The *consumer price index* measures average changes in prices of a list of goods and services purchased by families of urban wage earners and salaried clerical workers. This index is based upon prices collected on about 300 items selected by the Bureau of Labor Statistics as representative of thousands of commodities and services purchased by these families. The items include food, apparel and such major service categories as hous-

ing, transportation and medical care. Each item is assigned a weight based on surveys of 1952 consumption expenditures.

The *wholesale price index* measures price movements of commodities in primary markets. It is based on price quotations for approximately 2,000 items selected as representative of all commodities sold on these markets. The items are classified in major groups, sub-groups and product classes. Indexes are published for each of these specialized groups as well as for all items combined. In the computation of the indexes the price quotations are weighted in accordance with value of shipment data obtained primarily from the 1958 *Census of Manufactures*. Most users of the WPI are interested mainly in one or a few of the specialized group indexes.

In addition to these broad indexes, there are numerous others which are much narrower in scope and sometimes limited to special purposes. Perhaps the most widely known of these are the indexes of prices received and prices paid by farmers and the various stock market price indexes.

afford flexibility in introducing the many new items or product variations that occur annually. Last year, for example, compact cars, liquid detergents and a number of new drugs and food items were added or substituted for older products in the CPI. Major product innovations, such as television, which occur less frequently and can have a major impact on consumer expenditures for other goods and services, are another matter, however. Their introduction requires "fairly comprehensive" re-examination and assigning of weights—a necessarily time-consuming process.

Which prices?

The study committee also suggested that the wholesale price index may not accurately reflect price changes since it is based largely on list prices collected from manufacturers by mail survey. List prices often remain fairly inflexible while actual sales frequently reflect discounts or the inclusion of extra charges. In such circumstances, the index would tend to fall less during recessions than actual prices and in subsequent periods of business expansion would not rise as strongly. The committee urged that greater efforts be made to collect wholesale prices from buyers in order to improve the accuracy and sensitivity of the index. Other witnesses, however, estimated that the higher cost of this approach would more than offset the value of any improvement that might be gained.

Another recommendation, that the price indexes be seasonally adjusted as are most other major economic series, also elicited only limited support. The BLS pointed out that users of the indexes had expressed little interest in seasonally adjusted data and suggested that since seasonal variations were relatively small those who wanted data with the seasonal effects removed could largely

accomplish this by using quarterly or semi-annual averages.

A welfare index?

Should an index measure changes in the price of a specified list of goods and services or changes in the cost of maintaining a constant level of living? The study committee argued that the CPI seemed to be used principally as a constant utility or welfare index and suggested that it be modified to bring it closer to this objective. For example, the purpose of escalation clauses in wage contracts, in which the CPI has come to play an integral part, ". . . is to adjust wage rates in periods of general price change so the wage earner . . . will be able to maintain his 'standard of living'."

Most of the witnesses, however, considered the concept of a welfare index as too "illusory." Some felt it would not be a good index to measure changes in the purchasing power of the dollar. The BLS agreed that a welfare index would be "a useful statistical instrument," but cautioned that it would require "considerable further theoretical and statistical exploration." Until then, any movement toward a welfare index "would lead only to ambiguity and subjectivity."

The Congressional subcommittee stated that the extended discussion of the two kinds of indexes was not "sufficiently conclusive" to enable them "to formulate any recommendation in this area." However, it was recognized that a price index measuring changes in the price of a fixed list of goods and services ". . . would be unrelated to the fast-moving world we live in." It concluded that the concept of trying to measure ". . . the cost of a constant level of living . . . is worth additional work."

The recent review of the Government's price indexes emphasizes again the basic dif-

faculties of providing acceptable, comprehensive measures of price trends and suggests that such measures be used with considerable discretion in the formulation and evaluation of public policy and by private users as well. Opinion is sharply divided as to how adequate current indexes are, but there is general agreement that they can and should be improved in several ways.

Areas of agreement

Many committee proposals received general support, namely to: develop better export-import price indexes and a comprehensive construction cost index; broaden the scope of CPI coverage to include purchases by single persons and possibly rural nonfarm families; improve and expand reports describing the concepts and procedures underlying computation of the indexes; provide more funds for research in the Government's statistical agencies to study and test ways of

improving the indexes and to keep them abreast of the needs of the many different groups using them; adopt programs for periodic, comprehensive revisions of the weights of each major index at least every ten years.

It was recognized that these proposals, if adopted, would require additional expenditures. But the amount must be a matter of judgment since it is not the kind of decision determined automatically by market forces. Thus, the intensity of this need must be weighed against that of the many other demands for more and better service in both the public and private sectors of the economy. However, if the tendency in recent years toward broadening the use of the price indexes in the formulation and evaluation of national economic policies and in contractual arrangements in the private sector continues, efforts to provide accurate current measures of price changes probably will merit fairly high priority.

THE Trend OF BUSINESS

October brought evidence that the plateau in business activity noted early in the summer and prolonged by the auto strikes was giving way to renewed expansion in the fourth quarter. Consumers, at last, appeared to be increasing their spending on both hard and soft goods. In addition, Government officials have revised upward their estimates of total

Federal spending, reflecting primarily acceleration of the defense program and increased outlays under the various agricultural support programs. For the fiscal year ending June 30, 1962, the budget deficit is now expected to approach 7 billion dollars compared with an estimate of 3 billion last March and a deficit of 3.9 billion in fiscal 1961.

Continued easy conditions in the money and capital markets in recent months have been evidenced by fairly stable interest rates and a build-up of liquidity in financial institutions and business firms. In mid-October, commercial banks which report weekly to the Federal Reserve System held 14 billion dollars of Treasury securities maturing in less than one year compared with only 5.5 billion dollars a year ago. Short-term Governments accounted for 12 per cent of total loans and investments of these banks, up from 5 per cent a year earlier. These data indicate that commercial banks are better prepared to accommodate increased credit demands which may develop if activity rises further.

The relatively liquid position of commercial banks is also indicated by the fact that borrowings from the Federal Reserve Banks have been almost nonexistent for ten months. Not since 1950 have member bank borrowings remained so low for so long a time.

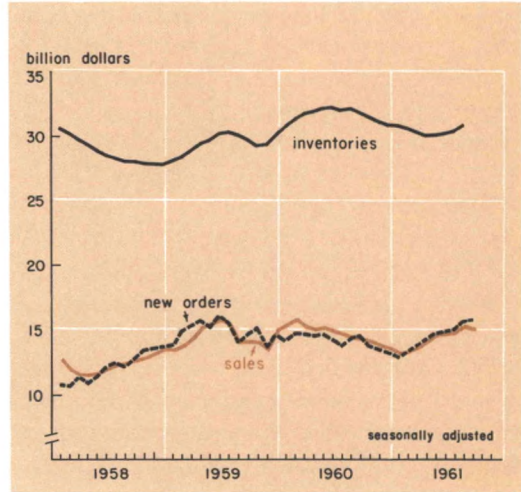
Consumer buying

Retail sales in the third quarter were at an annual rate of about 217 billion dollars, similar to the third quarters of both 1960 and 1959. Disposable personal income, meanwhile, was 4 per cent higher than in the third quarter of 1960 and 8 per cent above the same period of 1959.

During the first nine months of 1961 consumers, on balance, reduced instalment debt and added rapidly to liquid asset holdings. However, various surveys taken during the summer indicated they were becoming more confident and were planning to purchase larger quantities of automobiles, household appliances and furniture. In late September and early October there was evidence that these spending plans were being carried out.

Manufacturers' shipments of appliances, television and furniture were up substantially

Hard goods manufacturers increasing inventories as sales and orders rise



Note: Inventories plotted at end of month, sales are monthly totals.

over last year's levels in August and September. Retail sales of these items had increased only moderately since last spring, but dealers were sufficiently encouraged to add to their inventories in preparation for an expected further rise in business.

Retail sales of new automobiles were at a very low level in the first 20 days of September but, as the 1962 models became available in the later part of the month, sales rose sharply and this trend continued into October. Deliveries in the first ten days of October averaged 21,000 a selling day—a record for the period. Optimism was tempered, however, by the fact that virtually all manufacturers had introduced new models somewhat earlier than in previous years. On the other hand, some of the new models, partly because of strikes, were in short supply.

Department store sales provide further

evidence that consumers may be starting to step up their purchasing. In the third quarter, department store sales were at a record level, more than 3 per cent above the same period of 1960, which was the previous high. For the four-week period ending October 21, sales were 4 per cent above last year in the nation and 3 per cent in the Midwest. This showing is particularly impressive in view of the growth of the "discount" stores which are not included in these totals.

Business investment increasing

With attention focused on consumer and government spending in recent months, business inventories and investment in new plant and equipment have been out of the spotlight which they held early in the year. The current business expansion had been sparked by a turnaround in inventories—from liquidation to accumulation—and a rise in capital outlays which began relatively sooner than in previous postwar upswings.

Manufacturers' inventories rose by only 100 million dollars on a seasonally adjusted basis in the second quarter, but in the third quarter the increase is estimated at about 1 billion dollars. A Department of Commerce survey projects a further rise of approximately equal size in the fourth quarter. It appears therefore that inventory accumulation by manufacturers continues as a supporting factor.

Most purchasing officials of business firms, both in the nation and in the Midwest, report that they are accumulating higher inventories. As yet there has been only a slight tendency for lead-times to stretch out, a development which might spur faster placement of new orders.

From February through September new orders of durable goods manufacturers exceeded shipments, indicating a rise in un-

filled orders. New defense business has helped to boost these totals in recent months, although it is believed that the full impact of the expanded defense program will not be evident before next spring. New orders for machinery of all types, seasonally adjusted, rose from 4.8 billion dollars in January to 5.5 billion in September.

Early in October the Administration moved to stimulate equipment buying further by allowing textile firms to assign a "useful life" of 12 to 15 years to new equipment which formerly could be depreciated for tax purposes in no less than 25 years. Officials have stated that a broad liberalization of depreciation rules is being prepared and will become effective some months hence. Shortening of useful lives permits more rapid write-offs of the new equipment for tax purposes. Such a development, many businessmen contend, will encourage the purchase of depreciable assets.

Note

In the discussion of private pension plans on page 8 of *Business Conditions*, September 1961, it was indicated that earnings on pension fund investments administered by insurance companies were not exempt from taxes. With respect to life insurance companies, however, a tax exemption is envisaged by the new three-phase tax base concept (Title 26, Internal Revenue Code, sec. 801, et seq.) adopted for determining taxable income.