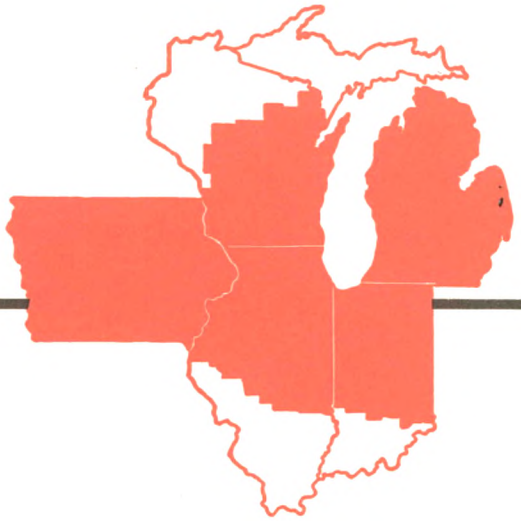
A review by the **Federal Reserve Bank of Chicago**

Business Conditions

October 1972



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THE Trend OF BUSINESS

Up, up, and away

It is now clear that the second quarter saw an exceptionally strong upward thrust in the growth trend of economic activity. The gain in real output, as measured by the constant dollar GNP, was at an annual rate of 9.4 percent. This rate has been equaled or exceeded only six times in the last 20 years, and only once, in the fourth quarter of 1965, in the past 12 years.

The data now available for the third quarter indicate that it too will show continuing improvement of the economy. It is unlikely that the growth in real output which occurred in the third quarter will turn out to have been at as high a rate as in the second quarter, but it will probably be significantly higher than the long-term average rate of 4 to 4½ percent. In fact, the momentum appears strong enough to insure a faster than average rate of growth for several more quarters.

What's ahead

The outlook for a continuation of good economic performance over the next several quarters is evident not only in the data, but also in the forecasts being made by economists throughout the country. Virtually all published forecasts now predict faster real growth than the historical trend at least through the second quarter of 1973. The National Industrial Conference Board regularly publishes summaries of the forecasts of several economic services and surveys. The median predicted growth rates for real GNP in the most recent compilation were:

1972 - 3rd Q	6.4 percent
1972 - 4th Q	6.1 percent
1972 - Year	6.3 percent
1973 - Year	5.8 percent

If the median forecasts for the last two quarters of 1972 were actually to be the results achieved, the gain for the year would not only be significantly better than most forecasts of last fall, it would also be higher than the forecasts made when only preliminary second-quarter data were available. The median growth rate predicted for 1973 is further evidence that most observers see substantial momentum in the data.

Employment

The economy generated an average of about 300,000 new jobs a month from mid-1971 until the middle of last March. Apparently, this rapid growth encouraged people to enter the labor force almost as fast as jobs appeared since the 2.6 million increase in the number employed had little impact on the unemployment rate. From mid-March through August, growth in both employment and in the labor force was slower and somewhat erratic from month to month, but it is clear that a definite improvement was occurring in employment.

The accuracy of the report of the sharp drop in the unemployment rate to 5.5 percent in June was questioned by some observers, but its accuracy has been verified by the data for July, August, and September. Total employment in September exceeded the March level by nearly a million persons. Despite this gain in the general level of employment, high unemployment rates persist for people under 25, particularly for teenagers.

Other indicators of the condition of the labor market have also shown significant strength in the past few months. The average workweek in manufacturing has moved up in recent months to the best level since the second quarter of 1969. The index of help-wanted advertising had moved up significantly in August and climbed again in September to 106, nearly 40 percent above the January 1971 low.

Price trends

Observers of the economy had generally expected that inflation, as measured by the rate of change of the GNP deflator, would be lower in the second quarter than the elevated rate of the first quarter, which included the bubble of price and wage increases resulting from the end of the freeze. Nevertheless, the low level which was reported was still a surprise. The increase at an annual rate of 1.8 percent was the lowest since the fourth quarter of 1965, with the sole exception of the last quarter of 1971, when the price freeze was in effect. In 17 of the 26 quarters since 1965, we have had inflation rates at least twice as great as the second quarter of 1972. The average rate for the four quarters ending with June 1972 was only a little more than half the average rate for the equivalent four quarters one year earlier. The most recent four-quarter period includes both the third and fourth quarters of 1971, covering the entire period of the wage-price freeze as well as the ensuing controls. The marked decline in the rate of inflation must largely be attributed to these controls.

Based on price index trends of recent months, it seems unlikely that third-quarter results for the GNP deflator will show as low an inflation rate as did the second quarter. After several months of moderate behavior, the consumer price index moved up sharply in July, with most of this increase the result of the still sharper rise in food prices. The rate of increase of the overall index slowed again in August to a much more acceptable rate. Even this increase was largely the result of continued increases in food prices. With the August 1972 level at 125.7, the index was 3.6 points above the level of one year previously, an increase of 2.9 percent.

In contrast with consumer prices, wholesale prices have been rising at a disappointingly high rate since April, with particularly large increases in July and August. The increase in September, although it was only half the August rate, brought the all-commodity index level to 120.2, about 4.5 percent above a year ago. As in the case of the consumer price index, food prices have played the major role in the rise of the wholesale index in recent months, and the slowing of the overall rise in the index from August to September was accompanied by a similar sharp decline in the rate of rise in farm products and processed foods and feeds. These wholesale price increases are likely to put pressure on consumer prices in the next month or two, making it difficult to foresee any possibility of an immediate reduction in the rate of rise of the consumer price index. Since the freeze had

its major impact in September and October of 1971, year-to-year comparisons are not likely to be very meaningful in the next few months for judging price trends.

Wages and income

While wage rate behavior has been somewhat erratic since the end of the wage-price freeze, the general trend has been toward a distinct slowing in the rate of rise as compared to the prefreeze period. Wage rate increases averaged over 6 percent in 1969, they accelerated further in 1970, and moved up still faster during the prefreeze portion of 1971. By contrast, although there were large wage increases because of adjustments and deferred raises in the immediate postfreeze months of December 1971 and January 1972, the average annual rate of increase for 1972 through July was significantly below the 1969 rate. From February on, there was a definite downward trend in the rate of increases. By August, the average annual rate had declined to 4.4 percent.

Although the rate of wage increases has been declining, the real spendable income of the average production worker has begun to rise in recent months after a long period of little movement, either up or down. June, July, and August increases in spendable income over the comparable period a year ago were each larger than 4 percent, and August was up sharply over July.

Total personal income, which had been rising strongly in the early part of the year, was set back slightly at midyear due to widespread flooding and related storm damage. But personal income turned upward strongly in July and showed another strong increase in August, rising at an annual rate of 9.25 percent. This continued rise, together with the impact of the increase in Social Security benefits due in the October checks, imply continued strong gains in retail sales.

Consumer purchases

The consumer, whose purchases contributed significantly to the total increase in gross national product in the second quarter, has apparently continued to spend during the third quarter. During the second quarter, consumer purchases of goods, both durables and nondurables, rose at a faster rate than total gross national product. This rise occurred even though retail sales slowed in June along with the setback in personal income. Retail sales rebounded sharply in July as the aftereffects of the spring storms diminished. August retail sales were also strong, but the preliminary data for September indicate sales were down from August, although still well above a year earlier.

Auto sales were very strong during July and August, with July setting a fourth consecutive monthly record, and August falling just short of making a fifth record month. The August sales of imported cars represented a 19 percent market share, sharply up from a less than 15 percent share in July. The abnormally low levels of inventories of 1972 domestic models probably accounted for the strong showing by imports. September domestic sales for the first two-thirds of the month were also down sharply compared to last year, when the combined effects of the price freeze and excise tax removal triggered a period of record sales levels. When cars became available late in the month, domestic sales soared, so that sales for the month were only slightly short of a record despite the lackluster performance of most of the month. September import sales, while a record for September, were down from August, and the import share of the market fell to about the July level. The 1973 domestic models are being

introduced with virtually no price increases so the industry is predicting very strong sales both for the fourth quarter and the 1973 model year.

The willingness of the consumer to spend has been accompanied by increasing willingness to take on debt. Personal borrowing has risen monthly by $1 billion or more for six consecutive months through August, and the August increase in instalment debt was almost $1.5 billion. While automobile credit was the leading contributor to the August rise, loans for other consumer goods also made a strong showing.

Housing

Most forecasts for housing starts for 1972 had predicted a gradual slowing from the high rates of the early part of the year. It was expected that 1972 starts would barely equal the 1971 level or even fall below it. The drop in the level of starts from June to July was generally heralded as evidence of this tapering down. However, August starts, at a 2.45 million rate, were the second highest of the year. Total actual starts for the first eight months are now more than 7 percent ahead of the same period last year. Adding to this strength is the fact that the rate of permits issued during July and August is about 8 percent higher than for the same two months last year. It now seems likely that with this level of permits, total housing starts for 1972 will exceed the 1971 level. Mobile home shipments in July dipped to a 572,000 annual rate from the 604,000 annual rate in June, paralleling the behavior of housing starts.

Industrial trends

The midyear pause in such indicators as personal income, retail sales, and housing starts, which has been attributed by many observers to spring storms and flooding, also showed up in the Federal Reserve Board's index of industrial production. There was virtually no increase in the overall index in June, and the July increase was noticeably slower than the gains recorded earlier in the recovery period. The gain in August to 114.3 percent of the 1967 average, while somewhat below the average for the first seven months, is more nearly in line with the rate appropriate to the gains in real GNP expected for the third quarter.

Beginning with August, and for the next few months, year-to-year comparisons of the industrial production index with its 1971 levels are not likely to be as meaningful as is normally the case because of the abnormal pattern of steel production last year. At least part of the August increase in the index of 8.2 percent over last August's level is due to this effect. The 6.4 percent increase for this July over the previous year is probably more indicative of the general current trend in industrial output.

The index for materials production, which has generally been outpacing the index for final products during the past several months, continued to do so in August. The defense equipment index continued its virtually uninterrupted recovery which began early in 1972, although it is still far below the levels of late 1968 and early 1969. Among the industrial groupings, mining and utilities continued to be weak, declining in both July and August, and durables continued to outpace nondurables, rising over twice as fast as the overall index.

The outlook for continued growth in manufacturing output for the rest of the year is enhanced by the continued growth of backlogs of unfilled orders. These backlogs have been climbing despite accelerating shipments during the third quarter.

The pace of manufacturing shipments picked up in July and increased again in August after sluggish movement in May and June. July shipments were 1 percent above the June level, and in August the seasonally adjusted level climbed 2.1 percent above July. Durable shipments provided all the gain in July, while August saw nearly equal gains for both durables and nondurables. For the two-month period, July and August, total gains were spread broadly over virtually every industry group and market category.

The level of new orders outpaced increases in shipments in both July and August. These increases continued a trend of rising backlogs that has continued uninterrupted since last October. Unfilled orders for durable goods account for well over 90 percent of the total. The August level of $76.7 billion in unfilled orders was 8.3 percent above the August 1971 level.

Inventories

The second-quarter results for inventory accumulation were awaited with considerable interest by many economists because the growth needed to keep up with accelerating business activity had not developed earlier. Inventory accumulation did contribute significantly to the total increase in GNP, even though the accumulation level remained low by historical standards, both absolutely and when compared with total GNP. In the fourth quarter of 1965, for example, inventory accumulation was nearly 1.5 percent of real GNP, while last quarter it was just under 0.5 percent of real output.

The preliminary indications for the third quarter are that inventory accumulation is still lagging the general growth of business output. While manufacturing inventories rose in both July and August, these rises were lower than would be expected in the light of the sales levels which occurred. At the end of August, inventories were only 3.1 percent above a year ago, while shipments had risen 13.3 percent.

Inventory/sales ratios continue to be very low by historical standards. For all manufacturing, the August ratio was 1.65, as compared to 1.82 one year earlier. For durables, it was 1.96, down from 2.21 a year earlier; for nondurables it stood at 1.29, compared to 1.36 the previous August. These low inventory ratios indicate that pressures are building to induce more rapid inventory accumulation, but the data for July and August do not indicate that a major inventory expansion had yet begun. Thus, inventories remained an area capable of supplying the base for considerable future growth of production in the rest of this year and well into 1973.

Business fixed investment

During the second quarter, business fixed investment grew at an 11 percent annual rate, about the same rate as total GNP. Producers' durable equipment outpaced the growth for structures. All of the indications available during the third quarter point to continuing good performance from this sector of the economy. Capital equipment appropriations and backlogs, contracts and orders for plant and equipment, and similar indicators are all at very high or record levels for the most recently reported periods.

The most recent Department of Commerce survey on capital expenditures indicates a somewhat smaller increase in capital spending for all of 1972 than indicated by the survey released in May. However, since spending in the first half was below previous expectations, the new survey ac-

tually represents an upward revision in the estimates for the second half of 1972.

While still low compared to the levels which prevailed during the 1960s, the ratio of output to capacity has turned up from the levels that prevailed during all of 1971. As output continues to increase, this indicator is likely to continue to climb, suggesting renewed pressure for plant expansion. The total impression of the entire business investment area is that this sector will provide a positive influence on economic activity for several quarters ahead in both inventory and fixed investment.

The travel gap

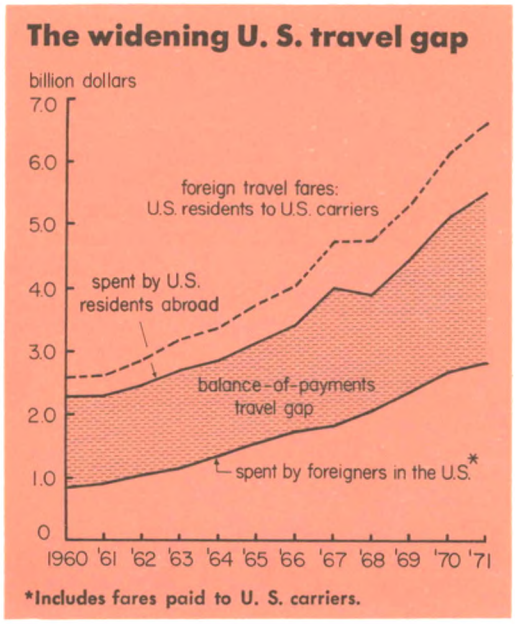
Last year, more than 5.5 million Americans traveled abroad for business or pleasure. They spent $5.6 billion in foreign countries for transportation, food and lodging, and gifts and entertainment. During the same period, 2.5 million visitors came to the United States from foreign countries, spending $2.9 billion here. The "travel gap"—the difference between the amount of money U. S. residents pay to foreigners in traveling to and within foreign countries and the amount of money foreign travelers pay to U. S. residents—reached an all-time high of $2.7 billion in 1971.

The persistence of the U. S. travel gap has been a source of concern for officials involved with the management of the nation's international balance-of-payments position. Deficits in the individual accounts of the balance of payments often exceed a country's overall deficit, being offset by surpluses in other accounts. The U. S. Travel Account has been traditionally in deficit. In eight of the past 12 years, the travel deficit equaled more than 50 percent of the total U. S. balance-of-payments deficit. And in two of these eight years, the deficit in the travel account was actually greater than the nation's total international deficit.

With few exceptions, travel expenditures of U. S. residents visiting foreign countries are treated as imports of goods and services, and travel expenditures of foreign residents visiting the United States are treated as exports of goods and services in the Current Account of the U. S. balance-of-payments accounting system. The Current Account measures net exports of goods and services, and net private remittances and transfer payments, such as pension payments. U. S. Government grants are also included. Two particular subaccounts—"Travel" and "Passenger Fares"—indicate the magnitude of travel-related outlays and receipts.

The Travel Account measures the expenditures of U. S. residents traveling abroad for such items as lodging, food, transportation within foreign countries, and all other personal purchases incidental to the trip. These expenditures have a negative effect on the U. S. balance of payments. The reverse is true for foreigners traveling in the United States. Their purchases within the United States have a positive effect on the balance of payments.

The Passenger Fares Account is less clear-cut than the Travel Account in that not all expenditures of U. S. residents for

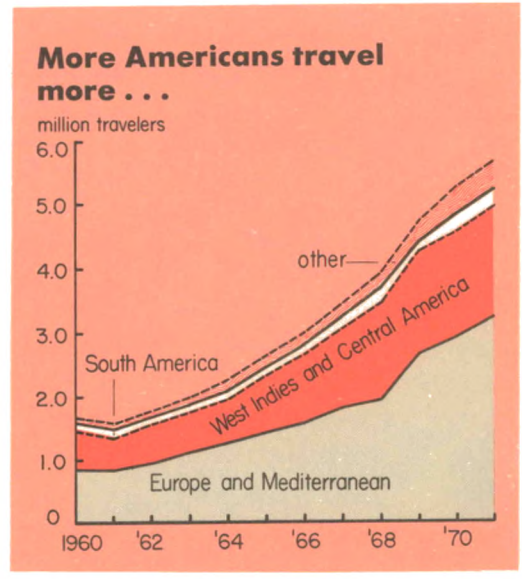


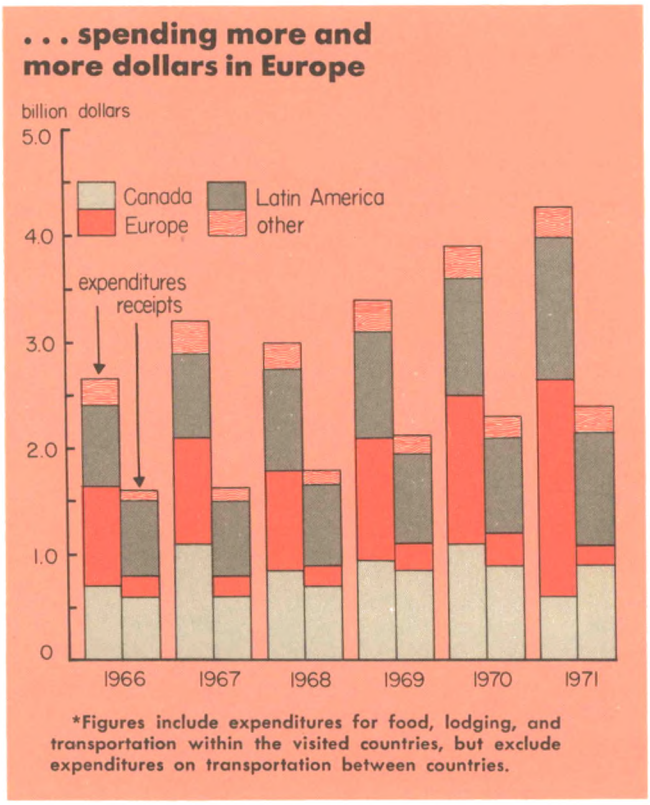
transportation to and from foreign countries have an effect on the balance of payments. An American traveling to or from Europe on a foreign carrier, in effect, imports a service from a foreign country. Similarly, a foreigner traveling to or from this country on a U. S. carrier creates an export for the United States. The U. S. resident's payment to the foreign carrier has an unfavorable effect on the balance of payments, and the foreign resident's payment to a U. S. carrier has a favorable effect. However, if the U. S. resident travels on a U. S. carrier, the fare is a domestic transaction, and is not included in the balance-of-payments account. Likewise, the foreigner transported to the United States on a foreign carrier represents a transaction between two foreigners and does not affect the U. S. payments position.

Taken together, the Travel Account and the Passenger Fares Account pit total expenditures of U. S. residents for foreign travel against the total expenditures of foreigners for U. S. travel. The difference between these travel-related exports and imports determines the travel gap.

The U. S. travel deficit: 1960-71

U. S. residents more than doubled their travel-related expenditures in foreign countries over the past 12 years. As recently as 1960, U. S. residents' travel expenditures within foreign countries amounted to $1.7 billion, and an additional $0.5 billion was paid to foreign carriers for passage—for a total $2.2 billion in U. S. "imports" of foreign services. By 1970, total expenditures in foreign countries and to foreign carriers had reached $5.2 billion, an increase of $3.0 billion in just one decade. Nearly $4.0 billion of the 1970 total was spent within foreign countries, and the remaining $1.2 billion went to foreign carriers for passenger fares. In 1971, U. S. travelers spent $4.3





billion in foreign countries, and paid $1.3 billion to foreign carriers. In addition, over $1.0 billion was paid to U. S. carriers by U. S. residents in their travel abroad.

Balanced against the large increase in U. S. travel outlays since 1960 has been a parallel expansion in spending by foreigners traveling in the United States. Total U. S. receipts from foreigners (including passenger fares) rose from $1.0 billion in 1960 to $2.7 billion in 1970, and to $2.9 billion in 1971. The net result of the 12 years of continued increases in both U. S. expenditures and U. S. receipts for foreign travel has been a widening of the deficit from $1.2 billion in 1960 to $2.7 billion in 1971.

Foreign destinations

Measured in terms of dollar expenditures for foreign travel, our neighbors, Canada and Mexico, are by far the most popular attractions for American travelers. Europe (including the Mediterranean area) is a close third. On average, 82 percent of U. S. residents' expenditures in foreign countries from 1960 to 1971 went to these areas. U. S. residents' travel expenditures in Canada and Mexico, although accounting for about 47 percent of total U. S. foreign travel expenditures, have contributed only a relatively small amount to the annual travel deficit, however. Over the period from 1960 to 1971, average annual outlays for travel in Canada and Mexico were $1,270 million. At the same time, average expenditures in the United States by Canadian and Mexican residents averaged about $980 million. This leaves an average annual deficit with Canada and Mexico of less than $300 million—only about 16 percent of the annual average travel deficit.

The travel balance with Europe and the Mediterranean area, in contrast to Canada and Mexico, has been far more adverse. This has been due largely to the sharp increase in the number of U. S. residents traveling to Europe in recent years. In 1960, approximately 832,000 Americans traveled to Europe and spent about $700 million—about $850 per person. By 1971, the number of Americans visiting Europe had increased to 3.2 million, and although average expenditures were much lower (about

$480 per person), total spending had increased to $1,540 million. Between 1960 and 1971, then, numbers increased threefold and expenditures more than doubled.

Traffic in the opposite direction on this two-way thoroughfare has not been nearly so heavy. In 1960, about 274,000 Europeans came to the United States on business or vacation and spent a total of about $90 million. In 1971, numbers reached 1.1 million and expenditures rose to $367 million. But the gain still left U. S. receipts from Europe in 1970 at about 50 percent of what U. S. expenditures in Europe were in 1960, even though the number of Europeans visiting the United States in 1971 was well above the 832,000 U. S. visitors to Europe in 1960.[1]

The net result of these flows and counterflows of people and money has been a sharp deterioration in the U. S. Travel Account balance with Europe. Rising from $600 million in 1960 to $1.2 billion in 1971, the deficit with Europe in the Travel Account represented, on average, about 45 percent of the total travel deficit. When one includes the Passenger Fares Account (and remembering that the great majority of foreign airlines are European-based), the average deficit with Europe in all probability accounted for 65 to 70 percent of the total annual deficit between 1960 and 1971.

The remaining 15 to 20 percent of the deficit is made up of U. S. residents' travel payments to, and receipts from residents of, all other countries in the world. Typically, the major attractions for American tourists in this category are the West Indies, Central America, and South America.

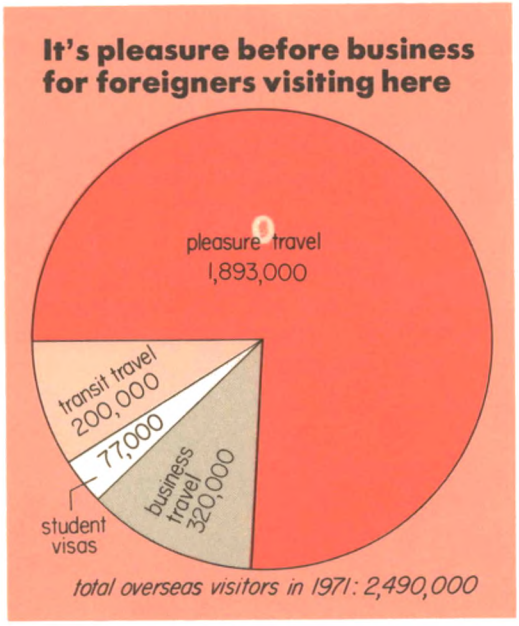
Why more overseas travel?

A variety of reasons can be mustered in an attempt to explain the increasing American propensity to travel overseas—particularly to Europe. However, four factors seem to stand out as having a dominant influence: rising real disposable income, increasing leisure time, decreased travel time to and from faraway places, and the declining cost of transoceanic transportation.

Per capita real disposable income in the United States (after-tax income adjusted for increases or decreases in the general price level), measured in constant 1958 dollars, increased by 38 percent over the last decade, from $1,883 in 1960 to $2,679 in 1971. One consequence has been a rapidly expanding middle-income class, with an equally rapidly rising pool of people now able and willing to travel abroad.

Overseas travel was once restricted to those with not only the financial means but also sufficient time to make the journey. A trend toward longer vacations combined with today's modern transport systems have made the time factor less inhibitive. The length of paid vacations in the United States has more than doubled in the past 20 years. In 1949, for example, 61 percent of all collective bargaining agreements called for two weeks paid vacations, and 33 percent asked for more than two weeks. By 1967, only 6 percent of all labor agreements called for less than two and one-half weeks vacation, while 60 percent allowed vacations of four to four and one-half weeks (an additional 12 percent incorporated over five weeks paid vacations).

[1]A plausible explanation of this phenomenon could be that, in many instances, European visitors to the United States board with relatives while here, eliminating a large portion of their expenses for food and hotels. In addition, many European countries, as well as other foreign countries, limit the amount of money their citizens can take out of the country for overseas travel. Both of these factors tend to hold down U. S. receipts.



The advent of the jet airliner in the late Fifties, by drastically reducing travel time to distant countries, has had pronounced effects on overseas travel and has made travel by air the most popular means of transportation with U. S. travelers. The number of U. S. residents traveling by air to overseas destinations has quadrupled since 1960, and over 98 percent of all overseas travelers, 5.6 million persons, went by air in 1971.

The final factor influencing U. S. residents to expand their foreign travel activities is the cost of air transportation. Unlike incomes and most prices, transoceanic air fares have declined sharply over the last 11 years. Average transatlantic air fares, for example, have been reduced from over $625 in 1960 to about $370 in 1971. For the most part, the reductions are due to various sales promotion arrangements and plans formulated by airline companies. The introduction of the "jumbo jet" had a further—and far-reaching—impact on cost in 1971, and will surely affect the travel patterns of both Americans and foreigners in the future.

Programs to improve the balance

The persistence of the travel gap elicited various programs to reduce it, including studies to determine the basic causes of the travel gap. It appears that the main causes of the deficit have been the relatively high per capita income in the United States, various restrictions on foreign travel invoked by foreign governments, the lack of an organized U. S. travel industry designed to accommodate non-English-speaking tourists, and the high cost of tourism in this country.

In an attempt to correct these shortcomings, the International Travel Act of 1961 established the U. S. Travel Service within the Department of Commerce. The task of the service is to design and coordinate programs that stimulate foreign travel in the United States. In 1965, the Cabinet Committee on Travel, Planning, and Promotion and "Discover America, Incorporated" were established. The cabinet committee's purpose was to coordinate the efforts of federal, state, and local governments and industry to improve travel receipts. Actions taken by the committee to meet this end include the creation of foreign language facilities at ports of entry, expansion of and improvement in the National Park System, and the simplification of custom's entry.

Discover America, Inc., a nonprofit, nongovernment organization comprised of persons from various segments of the tourist industry, has as its major purpose the task of promoting travel within the United

States by U. S. residents as well as by persons from foreign countries.

In addition to programs to increase the number of foreigners traveling—and spending money—in the United States, attempts were made to reduce spending by Americans abroad. In 1961, the duty-free limit on foreign-made goods brought home by U. S. travelers was reduced from $500 to $100 calculated on wholesale value. In 1965, this was changed to $100 retail value. In 1967, the President requested that Americans temporarily defer all unessential travel outside the Western Hemisphere.

It is difficult to say whether or not those programs have helped reduce the deficit. Their objectives were twofold—increase foreign residents' expenditures in the United States, and reduce U. S. residents' expenditures abroad. In the first respect, the programs appear to have worked: foreign expenditures for travel in the United States have increased over 200 percent since 1960. At the same time, however, U. S. residents have increased expenditures abroad by about 128 percent, causing a large deterioration in the travel gap.

The future of the travel gap

Improvement in the travel balance, almost assuredly, will be a long-run endeavor. Obviously, if the trend of the past decade continues, the travel deficit will continue to expand. With the 1972 tourist season almost behind us, it appears that the U. S. travel deficit will be larger than ever this year. It is estimated that 3.5 to 4 million U. S. residents will have traveled to Europe alone by the end of 1972. This in itself strongly suggests an enormous deficit. Current developments may serve to alter somewhat the travel activities of both Americans and foreigners during the next few years.

The future size of the travel deficit may well depend on the reactions of U. S. residents and foreigners to the recent international monetary changes. The dollar has been reduced in value vis-a-vis other currencies, and as a result travel in foreign countries became more expensive to Americans, while travel in the United States became less expensive for foreigners. At first glance, this situation appears to be beneficial in reducing the travel gap. But will it be?

The possibility exists that a devalued dollar would increase the travel gap. If U. S. residents planning a trip abroad continue to feel that additional costs are not prohibitive and carry through their plans, U. S. expenditures would increase substantially. Also, if the reduced cost of travel in the United States is not looked upon by foreigners as an incentive to travel here, U. S. receipts could fall. The combined effect would be a larger deficit.

Finally, and most important for the future of the travel balance, there is the prospect of lower overseas passenger fares. Normally, the cost of transportation is the largest single item considered when planning a trip abroad, and any change in fares will have a decided effect on foreign travel. When the 1973 tourist season begins in the late spring, potential travelers will probably find transatlantic air fares reduced once again. Will there be a standoff between lower air fares to Europe and the depreciation of the dollar? Only time—and the touring American—will answer that.

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