The Business Situation

The domestic economy posted a good gain in the second quarter, and early indications of July developments point to continued strength. The solid expansion in business activity in the April-June period brought over-all output to a seasonally adjusted annual rate of $658 billion, higher than had generally been expected. Notwithstanding the fact that steel stocks probably will be run off over the latter portion of the year, there are good indications that business activity will remain on an uptrend over the balance of 1965. Businessmen's spending plans, which point to rising outlays for plant and equipment in the months ahead, may become somewhat firmer against the background of recently released highly buoyant second-quarter profits reports; Federal tax and expenditure programs should provide a more expansionary impact on activity than was the case in the first half of the year; state and local government expenditures should advance further; and consumers appear to be in a mood to continue spending their rising incomes. Thus, providing there is no major steel strike, prospects seem good for realizing or perhaps even exceeding somewhat the "standard" forecast, made at the start of the year, of $660 billion for 1965 as a whole.

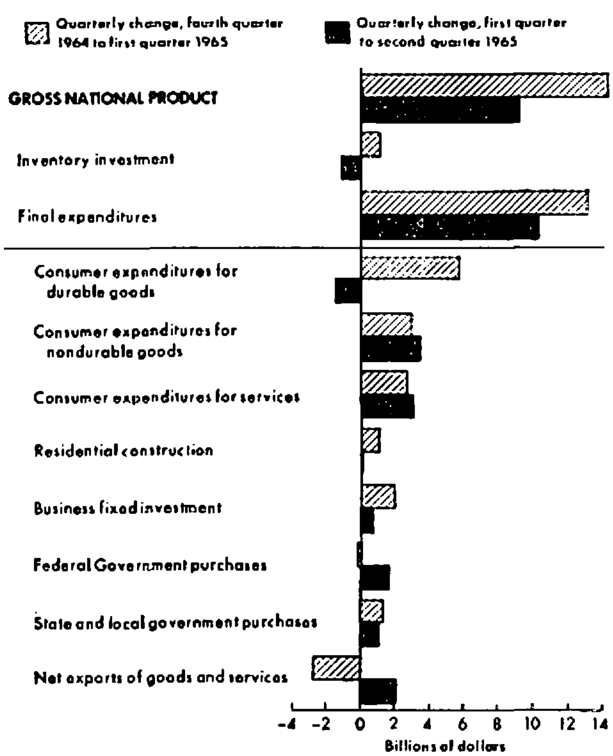
It is, of course, much too early to draw any firm conclusions about the prospects for still further advances during the early months of 1966. To be sure, it is entirely possible that the expected rundown of steel stocks may spill over into the first part of 1966. Moreover, the recently enacted increase in social security taxes will drain more from the private economy's income stream than will be restored through the second round of excise tax cuts scheduled for January 1. On the other hand, it is clear that the Administration's recent decisions with regard to Vietnam will result in additional Federal spending in the months ahead. The potentialities of stimulus from other areas of demand such as plant and equipment spending and residential construction will, of course, become easier to assess as the months unfold. It is reassuring that the Administration has indicated its continued concern with developing feasible fiscal policies that could be used to help sustain balanced over-all economic expansion should the need arise. In this connection, the Chairman of the President's Council of Economic Advisers recently stated that "we have the means, and I believe the will, to adjust the budget if that should be necessary, in a way which will contribute to the steady and adequate expansion of private purchasing power in the economy". The widespread confidence that much has been learned in recent years about the uses of fiscal policy to encourage business expansion will itself be a positive influence on business and consumer spending decisions.

While the prospects for continued economic expansion are bright, there remains the danger that such gains might spark further upward pressure on prices. The wholesale price index rose by 0.7 percentage point in June, the largest monthly advance since January 1964, and at 102.8 per cent of the 1957-59 average, the index was at a new high for the fourth consecutive month and 2.8 per cent above June 1964. Most of the June advance was attributable to higher prices for processed foods and meats, although prices for industrial commodities continued on their uptrend of the past several months, with price increases for hides and textile products supplying much of the pressure. The industrial component of the wholesale price index apparently edged up again in July amid reports of further price increases for hides. In the consumer sector, prices rose by 0.5 percentage point, the largest month-to-month advance in two years, and the index at 110.1 per cent of the 1957-59 average was 1.9 per cent above the figure in the corresponding month a year earlier. The June increase in the over-all level of consumer prices took place despite lower prices for new automobiles and air conditioners, on which excise taxes had been reduced retroactive to May 15, and was due mainly to sharply higher food prices. The substantial June run-up in food prices apparently reflected unfavorable weather conditions that are also expected to contribute to additional food price rises in July. This expected upward pressure, however, may be offset to a somewhat greater degree than was the case in June by lower prices for a large number of items on which the excise tax reduction did not take effect until June 22, after the data for the June index had been collected.

PATTERNS OF DEMAND IN THE SECOND QUARTER

Gross national product (measured at a seasonally adjusted annual rate) rose by $9.2 billion in the second quarter, according to preliminary estimates of the Commerce Department (see Chart I). The second quarter advance was, of course, markedly less than the unusually strong rise of $14.2 billion in the previous quarter, and would have been still less had there not been a sharp turnaround in net exports, which had been depressed by dock strikes in the January-March period. Even after allowing for this development, however, the slowing in business activity that did occur from the first to the second quarter seems to be largely accounted for by the absence of the special circumstances stimulating the steel and automobile industries that had served as a temporary boost to over-all output in the opening months of the year.

Chart I
RECENT CHANGES IN GROSS NATIONAL PRODUCT AND ITS COMPONENTS
Seasonally adjusted annual rates



Source: United States Department of Commerce.

The only two major GNP sectors that showed declines in the second quarter were consumer purchases of durable goods and business inventory investment. In the consumer sector, the decline largely reflected the fact that automobile sales returned to a more "normal" level in the second quarter following the first-quarter surge. Consumer spending on nondurables and on services, in contrast, both rose by more than the increases in the first quarter, indicating that consumers continued to be in an over-all spending mood. In July, unit sales of new automobiles chalked up another strong performance, while the dollar volume of total retail sales apparently moved past the record set in May.

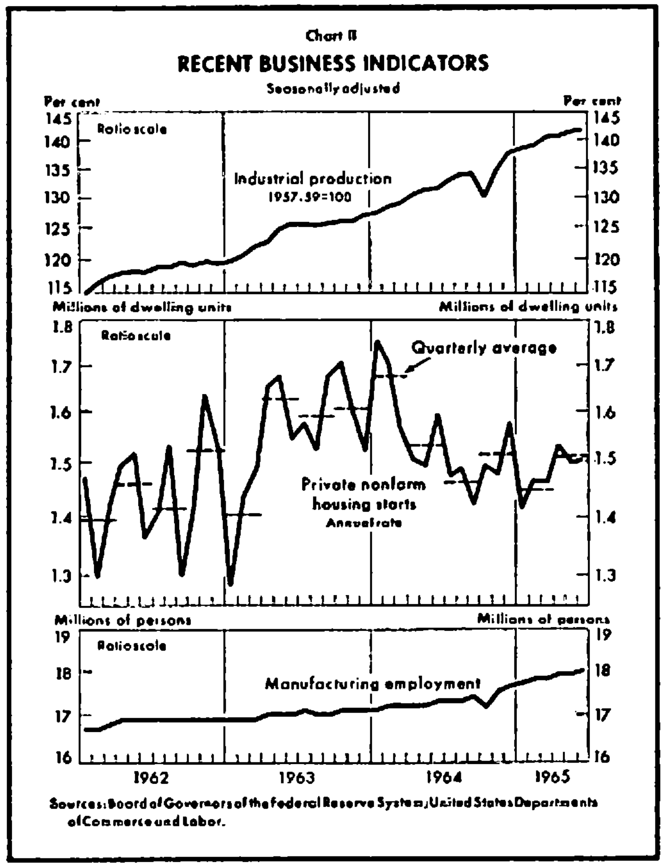
The decline in the rate of inventory investment during the second quarter can be traced in good part to recent fluctuations in the pace of steel stockpiling. With steel users facing the possibility of a steel strike after April 30, the rate of stockpiling was heavy in the fourth quarter of last year and in the first quarter of this year. While steel inventory building continued after the interim labor settlement was reached in April, the pace was much less rapid. That industries generally have continued to maintain close over-all control on their inventory positions is suggested by the further decline in inventory-sales ratios during the second quarter.

Among other sources of demand, business spending for plant and equipment moved up by $0.7 billion in the second quarter, right in line with the gain called for by the latest Commerce Department-Securities and Exchange Commission survey. This rise in capital outlays, a good part of which was apparently devoted to an expansion of capacity, has been reflected in a further continuous rise in industrial and commercial construction. Residential construction outlays, which turned up in the first quarter following movements on the down side in the three previous quarters, rose very slowly in the April-June period. Foreshadowing indicators of residential activity, however, continue to hold out the possibility of some further modest strength in this sector. Thus, nonfarm housing starts were up a bit in June, with the average for the second quarter some 4 per cent higher than in the opening quarter of the year (see Chart II).

In the government sector, outlays were up by $2.6 billion in the second quarter, with purchases at both the Federal and the state and local levels showing appreciable gains. Even with the rise, however, Federal purchases were still little changed from the level of a year earlier. In the months ahead, however, Federal expenditures on goods and services are scheduled to expand further, in part, owing to stepped-up outlays for defense. The recently enacted increase in social security benefits will add substantially to Federal cash disbursements in the last half of this year and thus add to private spending.

PRODUCTION, ORDERS, AND EMPLOYMENT

The Federal Reserve Board's seasonally adjusted index of industrial production rose in June for the eighth consecutive month, advancing by 0.5 percentage point to 141.9 per cent of the 1957-59 average (see Chart II). The June gain for the most part reflected a considerable further expansion in output of industrial materials, although production of consumer goods and equipment also showed small advances. The step-up in materials output, in turn, was apparently largely attributable to further increases in seasonally adjusted steel production. Weekly data for July indicate that automobile workers assembled new cars at a pace close to the seasonally adjusted annual rate of 9.6 million units of the month before, despite shutdowns at some plants for model change-over toward the latter part of the month. Steel ingot producers, on the other hand, increased their already advanced rate of activity in an effort to work down their order backlogs before a possible strike that could take place on or after September 1.



New orders booked by manufacturers of durable goods in June were essentially unchanged following a decline in the month before. New bookings in the transportation equipment producing industry fell off in June, largely because of a sharp cutback in the often erratic and volatile flow of orders registered by producers of aircraft and parts. Excluding the transportation equipment producing industry, new orders for hard goods actually posted a modest advance. At the same time, the backlog of unfilled orders held by such producers moved up for the eighteenth month in a row, and the ratio of unfilled orders to shipments, at 2.8, was over 5 per cent above the figure in the corresponding month a year ago.

The number of persons on nonfarm payrolls rose by 208,000 (seasonally adjusted) in June to 60.3 million, a solid 2.2 million above the reading for the corresponding month last year. Employment gains were widespread in June, with a particularly large increase in the manufacturing sector as producing and fabricating industries added significantly to the number of workers on their payrolls (see Chart II). In July, according to the household survey, total employment expanded for the ninth month in a row, and the gain was considerably greater than the concurrent increase in the civilian labor force. As a result, the overall unemployment rate moved down 0.2 percentage point to 4.5 per cent, the lowest reading since October 1957, with all major worker groups sharing in the improvement.