The Business Situation

The economy made further good gains in the summer months, and the prospects for sustained strength in the fall and winter remain excellent. To be sure, the long-awaited labor settlement in the steel industry, which was preceded by many months of strike-hedge stockpiling by users of the metal, most probably signals the start of a re-adjustment toward lower and more normal steel inventories. But the dampening impact of a decline in inventories on over-all demand in the months ahead is likely to be offset, if not more than offset, by increases in consumer spending, business outlays for new plant and equipment, and expenditures by all levels of government. The latest surveys of consumer sentiment point to continued strength in this demand sector. Furthermore, the latest (August) Government survey of businessmen's actual and planned capital spending in 1965 points to a 13½ per cent increase this year, as against a 12½ per cent increase projected at the time of the May survey. The National Industrial Conference Board has reported that manufacturers' capital appropriations showed a very sizable further advance in the second quarter and that partial survey results point to another gain in the third quarter, confirming the present as well as future strength in capital spending. Moreover, private demand will be buoyed by the acceleration of defense spending. Indeed, the prospect of expanding demands for military hardware may tend to dampen the pace of the expected rundown of steel inventories.

To date, most estimates still suggest that defense spending in the current fiscal year will be only moderately greater than projected in the Federal budget last January. Yet, the expansion of the American military commitment in Vietnam may quite possibly intensify the upward pressures on prices that were already in evidence prior to the July decisions concerning the military buildup. On the other hand, the wage settlement in the steel industry appears to be about in line with the Council of Economic Advisers' guideposts, in contrast to earlier settlements in some other major industries.

The uptrend of the wholesale price index slowed in July, when industrial commodity prices remained stable on balance. Weekly data indicate that the advance of industrial prices was renewed in August, although offsetting price declines for farm products and foods may have left the over-all index for that month unchanged. The advance of consumer prices also moderated in July because the excise tax cuts effective that month led to price reductions for various nonfood commodities. These reductions very nearly offset the effects of further price increases for foods and services, and the over-all index rose by only 0.1 percentage point to 110.2 per cent of the 1957-59 average. Government estimates indicate that, in the absence of these reductions, the index would have risen to 110.4 per cent. While it is gratifying that the tax cuts have thus in large part been passed on in terms of lower consumer prices, they cannot of course be expected to have much, if any, further moderating effect on such prices. The economy is clearly vulnerable to inflationary pressures in the current circumstances of strong demand in markets for both labor and goods, although there is no present evidence that an inflationary spiral is actually under way.

PRODUCTION, ORDERS, AND EMPLOYMENT

The normal summer slowdown of industrial activity has been unusually mild this year, and producers in a broad range of industries report that customary vacation shutdowns have been curtailed or even omitted. The brisk pace of activity is reflected in the Federal Reserve Board's seasonally adjusted production index, which registered a further substantial gain in July, rising by 1.2 percentage points from the upward-revised June level to reach 143.6 per cent of the 1957-59 average. The July advance was centered in durable goods which, in turn, were paced by gains in the output of equipment and of industrial materials, particularly steel. Production of consumer goods, on the other hand, was unchanged in July, with automobile assemblies remaining at the high June rate of about 9½ million units annually.

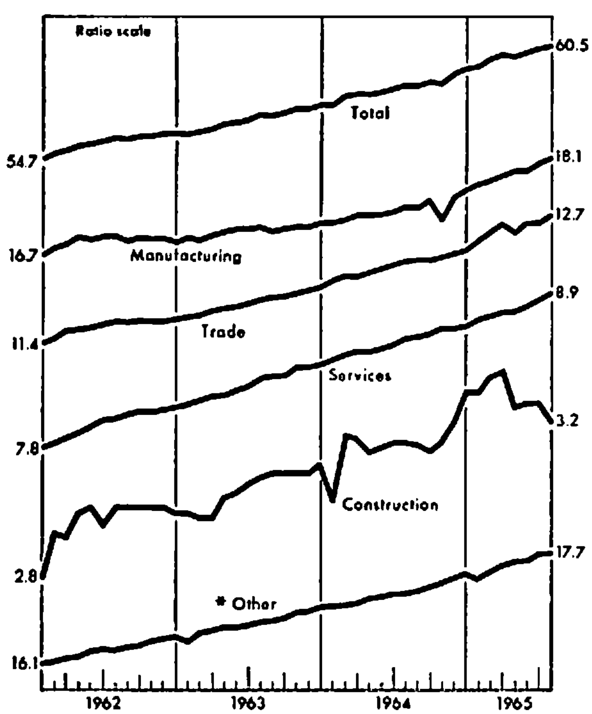
Fragmentary data suggest that over-all production rose again in August, even though steel output was cut back as both producers and users began to plan for the reduction of the inventories accumulated in anticipation of a possible strike. In the auto industry, August was marked by shutdowns for the changeover to production of 1966 models, and actual output was thus at a seasonal low. However, manufacturers were most anxious to provide dealers with adequate stocks prior to the introduction of the new models in early October. Therefore, shutdowns were shortened and new-model production begun as rapidly as possible and, after allowance for seasonal factors, the assembly rate in August was maintained at about the advanced June-July pace. Trade sources see a good chance that production, which was at a seasonally adjusted annual rate of 9.5 million units in the second quarter, will post a more than seasonal gain in the third quarter as a whole. Many observers are looking for total output in 1965 to be slightly over 9 million units, which would handily surpass the previous record of 7.9 million set in 1955.

The outlook for continued strength in durables production was further improved in July by an upsurge in new orders for such goods, which rose by 3 per cent to a volume only fractionally below the record set in April. It is noteworthy that the over-all advance was centered in industries oriented to civilian production, as defense orders edged up only slightly in July. Orders for machinery and equipment registered a particularly good advance of 6½ per cent, no doubt reflecting in good part the sustained growth of capital spending. While shipments of durables also rose—to a record volume—the backlog of unfilled orders on producers' books nevertheless expanded once again.

Chart I

RECENT DEVELOPMENTS IN NONFARM PAYROLL EMPLOYMENT

Millions of persons, seasonally adjusted



* Includes finance, government, mining, transportation, and public utilities.

Source: United States Bureau of Labor Statistics.

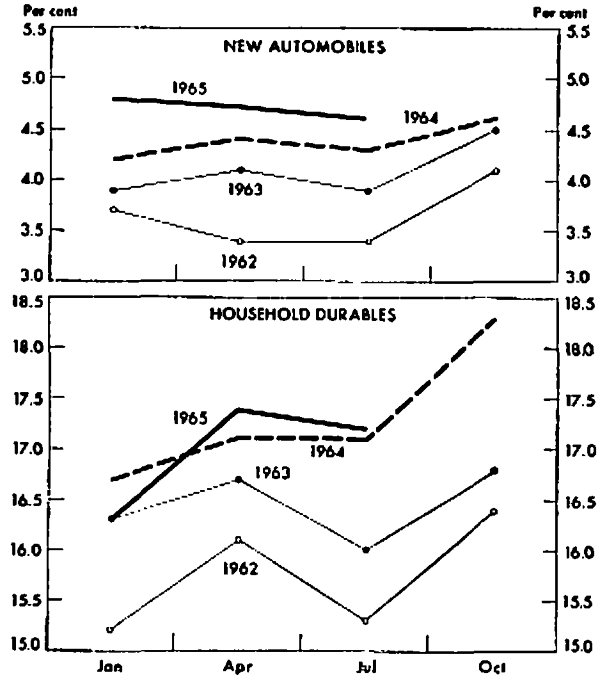
The brisk pace of economic activity in July was reflected in a further gain in nonfarm payroll employment (see Chart I). Employment in manufacturing industries increased by nearly 100,000 persons to 18.1 million persons, thus slightly exceeding the old record set in the middle of World War II. The fact that it took twenty-two years for this new record to be set reflects, of course, substantial gains in manufacturing productivity as well as the rapid reorientation of the economy toward service industries and public employment in the postwar decades. Nonfarm employment in sectors other than manufacturing has expanded by no less than 17.8 million persons during the intervening years, from 24.6 million in November 1943 to 42.4 million in July 1965. Since last winter, however, employment has been rising at a somewhat faster rate in manufacturing than in other major sectors. Manufacturing activity in a number of industries has been running at very high rates of capacity utilization and, in those industries experiencing particularly rapid demand expansion, producers are finding it increasingly difficult, at least in the short run, to expand output by the substitution of new capital equipment for the additional manpower that has so far been readily available. In August, both the total labor force and total employment declined, but since the reductions were about equal in size the over-all unemployment rate was unchanged from the July reading of 4.5 per cent. The stability of the over-all rate reflected offsetting developments for adults and teen-agers. While the unemployment rates for adult men and women both rose a bit, the teen-age employment situation showed a welcome further improvement and that group's rate dropped from 13.2 per cent in July to a three-year low of 12.4 per cent in August.

CONSTRUCTION SPENDING AND CONSUMER DEMAND

After staging a modest recovery during the first half of 1965, private nonfarm housing starts dropped off rather sharply in July and building permits also declined. It is true that both these indicators of future construction spending tend to be rather volatile, but the latest developments clearly give no ground for expecting any pronounced acceleration in home-building outlays over the near term. In fact, after trending slowly upward since the start of the year, such outlays declined in July and August. Nevertheless, industry analysts are cautiously estimating that the decline in starts has at last touched bottom, and that the rate of starts in the second half might equal or perhaps slightly exceed that of the first half. Such an outlook implies a continued slow growth of outlays, reflecting not only the rising costs of materials and labor but also the shift this year to the construction of somewhat more expensive types of housing units. On the other hand, outlays for commercial and industrial construction have been expanding this year more rapidly than most analysts had expected, with a good deal of the push coming from a renewed surge of office building. In large part, of course, the expansion of commercial and industrial construction activity is part of the growth of business capital spending. Another sizable advance in August brought seasonally adjusted expenditures for such construction in the first eight months of 1965 to a total about 15½ per cent above that for the same period last year. This component, however, accounts for only about 15 per cent of total construction spending, whereas private home building accounts for about 40 per cent of the total. (The remaining components of total construction activity—public construction and construction spending by utilities and institutions—have been virtually stable for some time.)

Chart II

CONSUMER INTENTIONS TO BUY NEW AUTOMOBILES AND HOUSEHOLD DURABLES WITHIN SIX MONTHS



Note: Buying plans are expressed as the ratio of the number of families who indicate they intend to buy to the total number of families in the survey.

Source: United States Department of Commerce, Bureau of the Census.

The latest Census Bureau survey of consumer buying intentions, taken in mid-July, points to continued strength in consumer demand (see Chart II). The proportion of families planning to purchase a new car within six months was well above the year-earlier reading, and the proportion planning to buy one or more of the seven household durable goods included in the survey was also higher than at the corresponding time a year ago. To be sure, buying plans in both categories contracted a bit between mid-April and mid-July, but such a movement is in line with the usual seasonal pattern shown in this survey. Thus, these midsummer results tend to bear out the findings of another survey of consumer sentiment taken in early June by the University of Michigan's Survey Research Center, which showed a high degree of consumer optimism over the prospects for continued general improvement in the economy as well as for the economic circumstances of the individual respondents.

Sales volume at retail outlets, after showing a slight dip in June, advanced strongly in July to a new high, with virtually all lines of trade sharing in the gains. Retail sales in July probably received some added impetus from the Federal excise tax reductions, and further stimulus is likely over the months ahead as consumers adjust to the fact that many previously taxed items now cost less. Government estimates indicate that, as of July, some 75 per cent of the total potential benefit of the tax cuts was being passed on to buyers in the form of lower retail prices. It had been expected, of course, that the number of new-car sales would benefit significantly from the excise reductions which, for autos, were retroactive to May 15. Unit sales, after declining from post-strike highs, did jump sharply in June and edged slightly higher in July to a seasonally adjusted annual rate of nine million cars, which was about equaled in August. However, the 1965 cars have enjoyed buyer enthusiasm throughout the model year, and it is virtually impossible to disentangle the specific effects of the tax cut. Industry sources forecast a strong October start for the 1966 cars.

REVISIONS OF GROSS NATIONAL PRODUCT ESTIMATES

The Commerce Department has released a revised set of gross national product estimates, incorporating changes back to 1929. The revisions are comprehensive, but it is noteworthy that the new figures show substantially the same quarter-to-quarter movements in GNP that had been indicated previously. In particular, the pattern of GNP growth during the current business expansion continues to look very much as it did prior to the revisions. For the earlier years of the postwar period, the net effect of the revisions has been to reduce GNP slightly, while for more recent years GNP has been increased moderately. Since the figure for 1964 has been scaled upward by about 1 per cent, from $622.6 billion to $628.7 billion, business analysts will find it desirable to make a similar upward revision in their forecasts for 1965 as a whole. For example, the frequently cited "standard" forecast has put GNP this year at $660 billion, up by 6 per cent from the unrevised figure for 1964. The same percentage increase, applied to the revised figure for 1964, implies a revised "standard" forecast for 1965 of roughly $667 billion.

One result of the revisions which is of particular interest is that the new figures show a slightly higher rate of growth of "real" GNP during recent years. Thus, the previous estimates showed GNP, measured in dollars of constant purchasing power, growing by an average of 4.1 per cent annually in the 1960-64 period, while the revised figures put the average annual growth at 4.3 per cent.

The regular summer revisions of GNP figures for the past few years have each reflected the use of more reliable data that become available only after some lapse of time. This year's revisions, however, are unusually extensive. They incorporate the results of using better data not only for the past few years but for earlier years as well, and they also reflect some changes in the definitions that determine which items are to be included in calculating the value of the economy's total output of goods and services. The last time the national income accounts were given such an extensive overhaul was in 1958. The largest of the "statistical" revisions — those reflecting the use of better data— is in the estimated value received by homeowners from the houses in which they live. This "imputed rent", which is classed in GNP as consumption spending for a service, has been increased because Government studies indicate that the nation's stock of housing in the postwar years has been of better quality than had previously been believed. Other "statistical" revisions resulted, among other changes, in increases in outlays for residential construction and producers' durables. With regard to the "definitional" revisions, the largest change is the removal from GNP of interest payments by consumers. These payments were formerly counted as personal consumption of a service but have now been excluded on the ground that they do not reflect any production. This and other definitional revisions generally reduced GNP below the levels previously estimated. For recent years, however, the definitional revisions were more than offset by the increases resulting from the use of better data.