The Business Situation

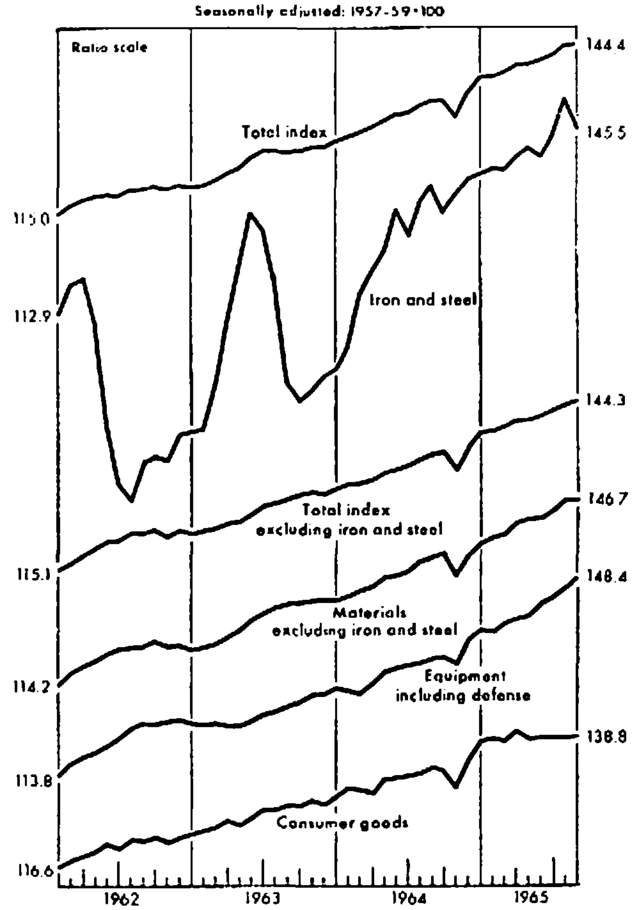
The economy has been spared the serious dislocations that would surely have stemmed from an extended steel strike. Nevertheless, the rate of economic expansion will clearly be influenced during the remainder of the year by readjustments in steel inventories and steel production. Early indications are that the readjustment has been moderate to date, and may possibly be milder than many observers had previously anticipated. While it must be expected that liquidation of steel inventories will continue for a time to have some slowing effect on industrial production and manufacturing employment, the dampening impact on the expansion of over-all demand should be readily absorbed by sustained strength in various other sectors. The prospects for consumer purchases and business capital spending remain favorable. Furthermore, recent defense and other Federal budgetary developments suggest that the net impact of Federal Government spending policies during the balance of the current fiscal year may turn out to be considerably more stimulative than earlier estimates had indicated.

Basically, the economy continues to be characterized by considerable strength in current and expected demand, and the margin of unutilized resources has shrunk substantially over the past year. The danger of upward pressure on prices therefore is real, although there has recently been an encouraging slowdown in the advance of the broad price indexes.

PRODUCTION, ORDERS, AND EMPLOYMENT

Industrial output edged up a bit further in August and pushed the Federal Reserve Board's seasonally adjusted production index to a record 144.4 per cent of the 1957-59 average, up by 0.2 percentage point from the upward-revised July level (see Chart I). The advance occurred despite a 4 per cent drop in the seasonally adjusted output of iron and steel, as this decline was more than offset by a moderate rise in the production of other industrial materials and by a sizable expansion in the output of business equipment, especially machinery. The continuing uptrend of equipment production is in large measure a reflection of the sustained expansion of business capital spending. Since the start of the year, there has also been an upward push on industrial production from enlarged output of defense equipment, following a decline in 1964

Chart I
INDUSTRIAL PRODUCTION
Seasonally adjusted: 1957-59=100



Source: Board of Governors of the Federal Reserve System.

and virtual stability in the two preceding years.

Consumer goods output, the remaining major component of the over-all industrial production index, was about unchanged in August at the advanced level that has prevailed since the recovery early this year after last fall's auto strikes. Actual production of automobiles in both August and September was, of course, affected by assembly line shutdowns for the annual model changeover. Although it is difficult to make an accurate assessment of the seasonally adjusted production rate during the changeover period, it appears that the rate in both months was about unchanged from the July level of 9.4 million units annually.

The expected reduction in steel inventories is currently under way, and resultant declines in the output of ingots and of finished steel will most likely persist for a while. Ingot production alone moved off in September by 10 to 15 per cent (seasonally adjusted). However, mills report that orders volume has held up better than had been expected, with new orders continuing to exceed cancellations. The consensus in the trade appears to be that the level of "excess" inventory is smaller than had generally been estimated so that the production decline may be less severe than the cutbacks following some of the industry's earlier labor settlements. Underlying these optimistic appraisals is the fact that steel consumption is high and expected by many to grow further.

The pace of steel ordering was already slowing in August, as the approach of the strike deadline reduced the time available for deliveries prior to the threatened work stoppage. The decline in steel orders was a major factor contributing to a contraction in new orders for durable goods, which dropped by 3 per cent from July's upward-revised record. The steel industry also reported a sharp reduction in its backlog of unfilled orders, but the over-all backlog on the books of durables producers nevertheless expanded fractionally to mark the twentieth consecutive month of growth.

Nonfarm employment rose again in August, lifting the total number of persons on nonagricultural payrolls to 60.7 million (seasonally adjusted), up by 120,000 from July. Gains were experienced by all major industries except mining, but manufacturing employment advanced only fractionally as a modest rise in the nondurables sector was nearly offset by a small employment decline in the durables sector. However, the average weekly hours clocked by manufacturing production workers and their average overtime were both unchanged at the relatively high July levels. Indeed, a number of manufacturers, especially in the metal-working industries, reportedly continue to find that shortages of skilled labor necessitate the substantial use of overtime.

BUSINESS AND CONSUMER SPENDING

Further strength has developed in business capital spending plans for 1965 as a whole, according to the latest Commerce Department-Securities and Exchange Commission quarterly survey taken in August (see Chart II). Businessmen reported that outlays for new plant and equipment in the second quarter were $750 million greater (at a seasonally adjusted annual rate) than had been estimated in May, and that plans for third- and fourth-quarter spending had been scaled up since May. If the plans reported in August are realized, outlays this year will total almost $51 billion—an advance of 13.4 per cent. Previous surveys in February and May had estimated the 1965 gain at 11.7 per cent and 12.3 per cent, respectively. Thus far in 1965, there has been a pattern of gradual upward revisions in capital spending plans rather similar to that of 1964, when the year's final outcome was an increase larger than had been indicated even as late as the August survey. If the trend of upward revision again persists into the final quarter, this year's gain in spending may well approximate last year's increase of 14.5 per cent. Revisions for most industry groupings followed the over-all pattern, but were relatively large in the nonrail transportation, paper manufacturing, and motor vehicle industries. The automobile manufacturers, after upping capital expenditures by 42 per cent in 1964, foresaw in February a gain of 10½ per cent for this year; by May the figure had been pushed up to 25 per cent, and in August it reached 31 per cent.

The prospects are good that strength in actual capital spending will persist well into 1966. A recent National Industrial Conference Board survey indicates that manufacturers' capital appropriations continued to rise through the third quarter and that, despite the growth of outlays, backlogs of unspent appropriations are still expanding. The Conference Board has also reported that nearly 75 per cent of manufacturers expect to need additional capacity to meet demand a year from now. In fact, of the group so reporting, almost half find that capacity is inadequate at the present time.

Another midsummer survey, taken by the Commerce Department, found manufacturers optimistic regarding sales prospects. Sales gains in the neighborhood of 2 per cent each were generally expected for the third and fourth quarters. The survey results also pointed to generally favorable prospects for inventory demand by manufacturers. Manufacturers expected the rate of inventory accumulation to be slower in the fourth quarter, after a third quarter believed likely to equal the second-quarter pace. Nondurables manufacturers looked for modest step-

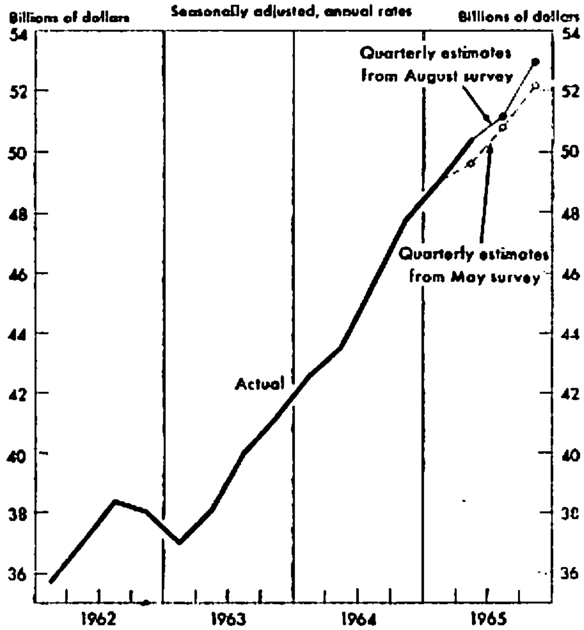


Chart II
ACTUAL AND ANTICIPATED PLANT AND EQUIPMENT SPENDING

Sources: United States Department of Commerce; Securities and Exchange Commission.

ups in the pace of accumulation in both the third and fourth quarters; the accumulation rate in the durables sector, on the other hand, was expected to slow down in both quarters.

The over-all rate of manufacturers' inventory investment rose sharply in the fourth quarter of 1964, reflecting partly the onset of steel stockpiling and partly a catching-up in nondurables stocks following a net decumulation over the first nine months of the year. In 1965, the actual accumulation rate in the first two quarters and that anticipated for the third quarter remained higher than in most quarters of recent years. The anticipated fourth-quarter slowdown in the pace of inventory accumulation reflects the expected swing to decumulation of steel stocks, which would be only partly offset by additions to other durables stocks and by the step-up in nondurables accumulation. Thereafter, the behavior of over-all inventory investment in manufacturing may gradually become free of the special effects of steel inventories.

Commercial and industrial construction has been advancing in recent months, reflecting the strength of capital spending. Residential construction, on the other hand, has remained a relatively weak sector in a generally strong business picture, and housing starts declined in both July and August. Despite a modest upturn during the spring, the seasonally adjusted annual rate of starts for the first eight months of 1965 has averaged only 1.47 million units, off by 4 per cent from the 1964 total of 1.53 million.

In contrast to the sluggishness of housing demand, retail sales continue strong and sales volume in August was about equal to the record high reached in July. Retailers are reported to be experiencing a good fall upswing, and weekly data suggest that sales volume (seasonally adjusted) may have expanded a bit in September. As auto dealers carried out an apparently successful cleanup of the 1965 models, sales of new domestically produced cars ran at a seasonally adjusted annual rate of 8.9 million units in August and probably declined in September toward the end of the cleanup period. The new models are being introduced during the first two weeks of October, and their reception by consumers will, of course, have an important effect not only on the auto industry but also on the economy at large. Manufacturers remain confident of another good year with their 1966 models.

WAGE AND PRICE DEVELOPMENTS

The support gained for the principle of noninflationary wage behavior through a steel settlement approximately within the Administration's guideposts is a welcome development. However, over the year preceding the steel settlement, labor contracts clearly in excess of the guideposts were negotiated in a number of other major industries. Labor costs per unit of manufacturing output, after showing a gratifying downtrend during the earlier years of the current business expansion, have been virtually stable since last winter as productivity gains have no more than offset the rise in hourly labor costs.

There was no increase in the over-all wholesale price index in August—the first month without an increase in 1965—as a small decline in agricultural prices from the seven-year peak reached in July offset a slight further rise in prices of industrial commodities. Much of the 2.6 per cent advance in the over-all index in the twelve months ended with August reflected the run-up in agricultural prices in the first half of 1965. The combined price index for farm products and processed foods moved down last fall but then shot up by 6.7 per cent from December to July; the August-to-August advance was 5.7 per cent. This marked rise was mainly attributable to tight supply conditions: shortages of fruits and vegetables resulted from poor weather and harvesting delays, while marketings of hogs and cattle were curtailed as a result of stockmen's reactions to the low prices that prevailed in 1963 and 1964. However, supplies have recently expanded, and weekly data indicate that agricultural prices may have declined slightly further in September.

Agricultural prices were not solely responsible for the upward movement of the wholesale price index through July. The index of industrial commodity prices in August was 1.5 per cent above its year-earlier level, although the uptrend in these prices appears to have slowed in recent months. The advance has been especially pronounced in metals and metal products, but most other major commodities have also moved higher. Although weekly data suggest that industrial prices may have been fairly stable again in September, it remains to be seen whether this favorable situation will persist. The prices of many industrial products are affected by world market developments in raw materials supplies, as well as by producers' attempts to offset rising costs and to widen profit margins during periods of strong demand. Specific industrial price announcements have recently been preponderantly on the upward side.

The over-all index of consumer prices fell in August for the first time in a year, but the decline was no larger than the expected seasonal movement. On a seasonally adjusted basis, therefore, the index was unchanged. The August decline in the unadjusted index was largely the result of reductions in consumer food prices, especially for produce. The previous sharp advance in food prices during the spring and summer was a major factor in the 1.7 per cent advance of the over-all index from August 1964 to August 1965—an annual rate of increase somewhat larger than has generally been experienced in recent years. The level of nonfood commodity prices did rise noticeably in the winter and spring, but then declined through the summer. However, this recent decline was partly attributable to the excise tax cuts, from which little if any further moderating effect can be expected. The long-term upward trend in the price of services has continued throughout the past year at about the previous rate.

TRADING IN FEDERAL FUNDS

The Board of Governors of the Federal Reserve System has just published its second technical study on the Federal funds market, entitled "Trading in Federal Funds—Findings of a Three-Year Survey", prepared by Dorothy M. Nichols of the Federal Reserve Bank of Chicago. The 116-page report focuses on variations in the size and distribution of flows of Federal funds. It also shows the continued growth in the importance of these transactions in the money market. The survey on which the study is based included nearly 250 banks throughout the country. They supplied the System with data on daily transactions in Federal funds for the three years ended in September 1962.

Copies of the study are available, upon request, from Publications Services, Division of Administrative Services, Board of Governors of the Federal Reserve System, Washington, D.C. 20551, at $1.00 each up to 10 copies and 85 cents each for 10 or more copies in a single shipment.