The Business Situation

The economy continues to move to new high ground, and business sentiment appears to have become progressively more confident about future prospects. Private residential construction activity was off again in November, but most other broad measures were up for the month. Moreover, the economy appeared to be gathering further momentum, with the unemployment rate declining once again. Orders already in hand appear to support the outlook for protracted strength in production over the near term. Meanwhile, consumer buying intentions remain high, capital spending plans are buoyant, and Government expenditures will be rising substantially. In view of these facts, several well-known business forecasts have recently projected a level of over-all activity in 1966 that implies a continuation of roughly the same rapid rate of growth that has been experienced over the past year and a half.

If these projections are realized, it seems likely that there will be a further lowering in the already reduced margin of unutilized resources. The labor market is already as tight as it has been at any time in the past eight years, and the unemployment that now exists appears to be more and more concentrated among workers without adequate skills and within a few localized pockets of surplus labor. There will, of course, be another substantial addition to the labor force next year, and the expected high level of capital spending will both increase physical capacity and add to labor productivity. Nevertheless, cost-price movements will continue to bear the closest scrutiny.

The recent cancellation of aluminum and copper price increases has helped dampen some of the fears of an imminent inflationary spiral, and although there has been a renewed flurry of price advances on a few industrial raw materials, such prices remain below their earlier peak in May. The consumer price index, however, moved to a new high in October. The increase for all commodities except food was the largest monthly advance in two years. The year-to-year rise since October 1964 amounts to 1.8 per cent, which is more than the increase that has characterized earlier periods of the expansion. The wholesale price index also climbed in October, making the over-the-year rate of advance 2.3 per cent.

OUTPUT, ORDERS, RETAIL SALES, AND EMPLOYMENT

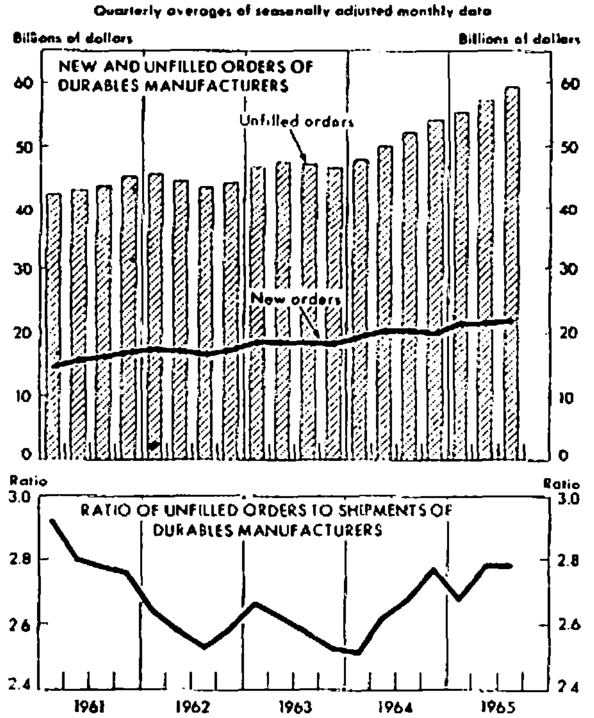
The Federal Reserve Board's index of industrial production rose by 0.6 percentage point in October to 143.6 per cent of its 1957-59 average. The advance was sufficient to recoup about half of the decline in September when reductions in steel inventories adversely affected total output. Furthermore, the October gain occurred in spite of the fact that steel inventories continued to exert a depressing influence—iron and steel output fell by 8 per cent during the month. In late November, there were signs that the decline in steel ingot production was bottoming out at an annual rate of roughly 105 million tons.

Among other industries in October, coal and crude oil output rose substantially as producers worked to meet impending winter needs and to make up for strike and hurricane losses during the preceding month. Output of business and defense equipment was also up markedly. Consumer goods production advanced at a slightly faster pace than on average earlier in the year, with increases in the production of home appliances, furniture, and nondurable consumer goods following a period of somewhat sluggish growth. The rate of automobile assemblies also moved ahead somewhat in October and, with a further rise in November, total assemblies for the first eleven months of the year amounted to 8½ million units. This means that the first eleven months already surpass the previous full-year record of 7.9 million units set in 1955. If December schedules are met, output for the full year will amount to more than 9.3 million units.

Near-term prospects for further strength in production remain good. New orders received by manufacturers of durable goods rose in October, despite a drop in Government orders placed with defense industries subsequent to a surge in such bookings during the summer. Moreover, the volume of new bookings remained above current shipments, with the result that backlogs of unfilled orders piled up further in most broad industry groups. The total backlog has risen sharply and steadily since late 1963. October marked the twenty-second consecutive month of increase, following a period of somewhat more modest growth earlier in the current expansion (see Chart I). Since the rise in backlogs has outpaced gains in shipments, the ratio of unfilled orders to shipments (also shown in the chart) has risen to the highest level since January 1961. The present backlog is equivalent to about three months of shipments at the current rate.

Longer term growth prospects for production are being bolstered by heavy current and prospective consumer demand. Retail sales were at a record high in October and appear to have remained near this level in November. These gains, moreover, occurred without any push from automobile sales, which declined slightly below the September rate. Some of the recent spending undoubtedly reflects a slightly delayed reaction to the bulge in consumer income in September when the Government made large retroactive payments for increased social security benefits. Consumers' buying plans continue to show strength, according to the Census Bureau's latest quarterly survey taken in mid-October. At that time, the proportion of households intending to buy a new car or an additional household appliance was at the highest level of the current expansion.

Chart I
INDICATORS OF DURABLES MANUFACTURERS' ACTIVITY
Quarterly averages of seasonally adjusted monthly data



Source: United States Department of Commerce.

Total payroll employment also advanced in November, and gains were widespread among industry groups. In manufacturing industries as a group, moreover, average weekly hours climbed to the highest level since June 1965. Overtime of manufacturing production workers remained near the record high established in October. According to the Bureau of the Census, the total labor force grew further during the month and the unemployment rate fell to an eight-year low of 4.2 per cent.

GROWTH AND UTILIZATION OF RESOURCES

Should economic activity continue to advance at roughly the 1965 rate over the year ahead, one crucial question would be whether this further growth can be met by the increase in the economy's resources of labor and capital without more severe supply pressures than now exist. Many economic projections indicate that greater tightness will prevail. For example, the University of Michigan's econometric model points to an over-all unemployment rate averaging 3.9 per cent in 1966, a 0.7 percentage point decline from the estimated 1965 average. Moreover, the large capital spending now planned for next year, the strength of consumer buying plans, and rising defense outlays suggest that capacity utilization ratios may advance beyond currently high levels, despite the continuous additions to plant and equipment.

The growth in the labor force is clearly among the key variables bearing on the question of future noninflationary expansion. Over the past four and one-half years of general business advances, the civilian labor force has been growing by about 1.0 million persons per year (see Chart II). The actual increase in the year ended in November 1965, however, amounted to 1.6 million persons. Despite this larger addition, the number of new jobs created by the growing economy has been sufficient to reduce the unemployment rate by 0.7 percentage point over these twelve months and by 2.7 percentage points since the expansion began in February 1961. Among married men, about 98 of every 100 wanting to work held a job in November, the highest employment rate for this key category since such data began to be collected in late 1954.

According to recent estimates by the Bureau of Labor Statistics, the total labor force is likely to increase by about 7½ million persons between 1965 and 1970, or by an average of some 1½ million persons per year (see Chart II). The projection of a substantially larger annual accretion in the next few years than in the early years of the present expansion reflects the post-World War II "baby boom". Even the enlarged increase in the labor force, however, is well within the bounds of the

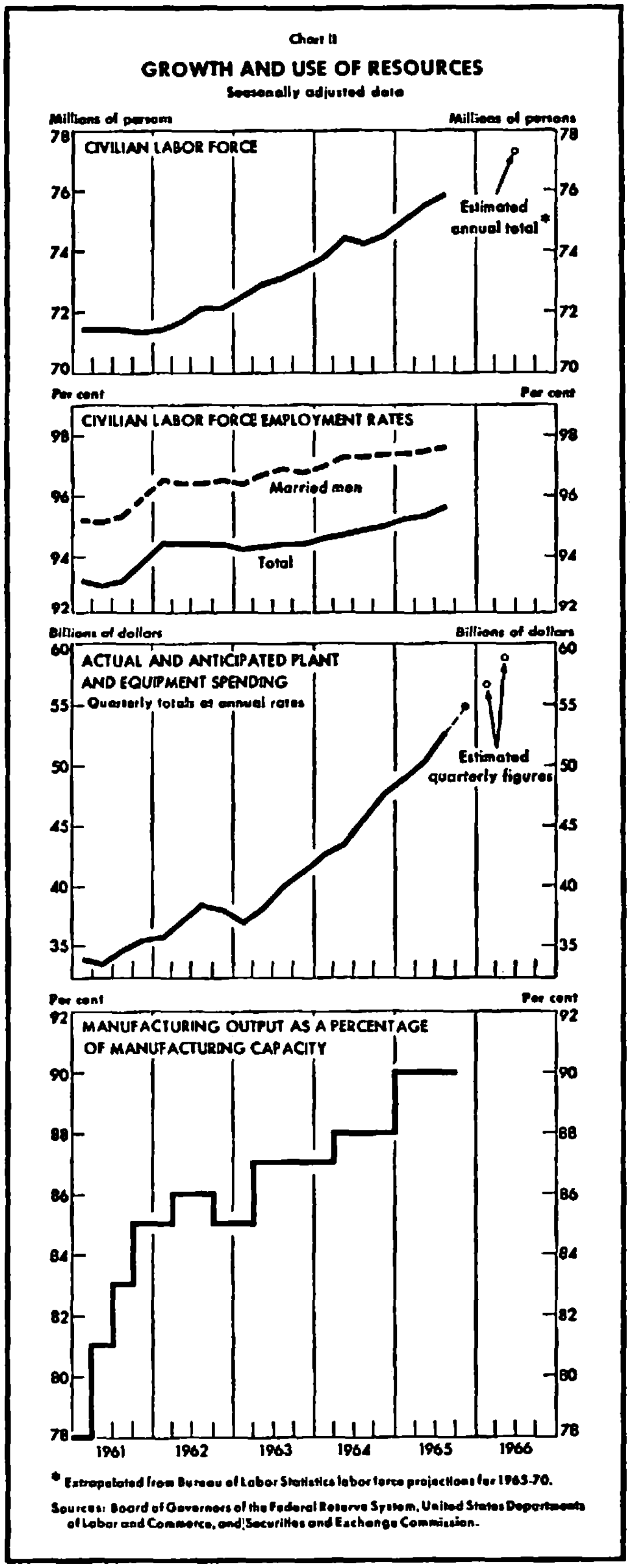


Chart II
GROWTH AND USE OF RESOURCES

* Extrapolated from Bureau of Labor Statistics labor force projections for 1965-70.
Sources: Board of Governors of the Federal Reserve System, United States Departments of Labor and Commerce, and Securities and Exchange Commission.

gain in over-all employment that the economy has generated in the past year. Moreover, since many of the new labor force entrants will initially be lacking in skills, they will not immediately alleviate the shortages of skilled labor that have become more and more evident.

Over the longer run, one major way of overcoming actual or potential labor shortages is of course to increase workers' productivity, which has already been growing rapidly during this expansion. In fact, real output per employed person has increased by some 3.2 per cent annually over the past five years. Productivity growth has been stimulated by the large and steadily rising volume of capital spending that businessmen have undertaken. Over the past five years, the amount of such spending—both for capacity expansion and modernization—has totaled more than $200 billion, and according to an upward revision in recent Department of Commerce-Securities and Exchange Commission estimates, nearly $52 billion will be spent in 1965 alone (see Chart II). This figure, if realized, would represent capital outlays 60 per cent higher than those in 1961. Moreover, the report indicates that businessmen now plan to increase such expenditures to an annual rate of nearly $57 billion in the first quarter of 1966 and to an annual rate of $58.8 billion in the second quarter of next year—gains of 9.4 and 13.5 per cent over the 1965 level. These estimates follow the fall McGraw-Hill survey, which already pointed to an advance in capital spending in the next year larger than that indicated in similar surveys of previous years.

Despite the increase in capacity that has stemmed from these capital expenditures, manufacturers as a group continue to operate at rates close to their preferred capacity utilization ratios. According to an index developed at the Board of Governors, operations have been running at around 90 per cent of capacity since the first quarter of this year, some 12 points above the level at the beginning of the expansion in early 1961 (see Chart II). Indeed, a number of industries—notably automobiles, nonferrous metals, rubber, textiles, and machinery—have reported shortages of capacity.

Given the persistent need to improve labor productivity and the long-run growth needs of the economy, the high level of capital outlays planned for 1966 is encouraging. But the very fact that capacity and skilled labor are presently in short supply means that further large additions to aggregate demand—as implied by these capital spending plans—will make for more pressure on available resources in the short run. The economy will have to surmount these pressures if further gains in activity are to continue to take place in a generally noninflationary environment.