The Business Situation

Economic activity continued to advance strongly across a wide front late in 1965. Business outlays for plant and equipment are running higher than previously expected, Federal expenditures for both military and domestic purposes have been increasing, state and local government spending is continuing to advance, and consumer demand is high and still rising even though acquisitions of durable goods have been sizable throughout the current expansion. Moreover, while aggregate inventory demand by business has declined in recent months as steel inventories have been worked down following the signing of labor contracts, this adjustment is apparently about completed.

Planned expenditures on plant and equipment, recently reported by the Department of Commerce and the Securities and Exchange Commission, indicate outlays in the first half of 1966 fully 16 per cent above the first half of 1965 and 7 per cent above the second half of 1965. Furthermore, a private survey taken since the commercial bank prime rate increase in December suggests that only a small proportion of the corporations questioned anticipated reducing their planned capital spending in 1966 as a result of higher interest charges, and all these cutbacks were expected to be less than 5 per cent. Consumer intentions to increase purchases in future months have moved up once again. Retail sales, which reached a record high in November, appear to have advanced further in December. Although it is too early to evaluate the effects of the January transit strike in New York City, it is clear that the strike depressed both sales and incomes in the immediate area, with consequent repercussions on the national economy as a whole.

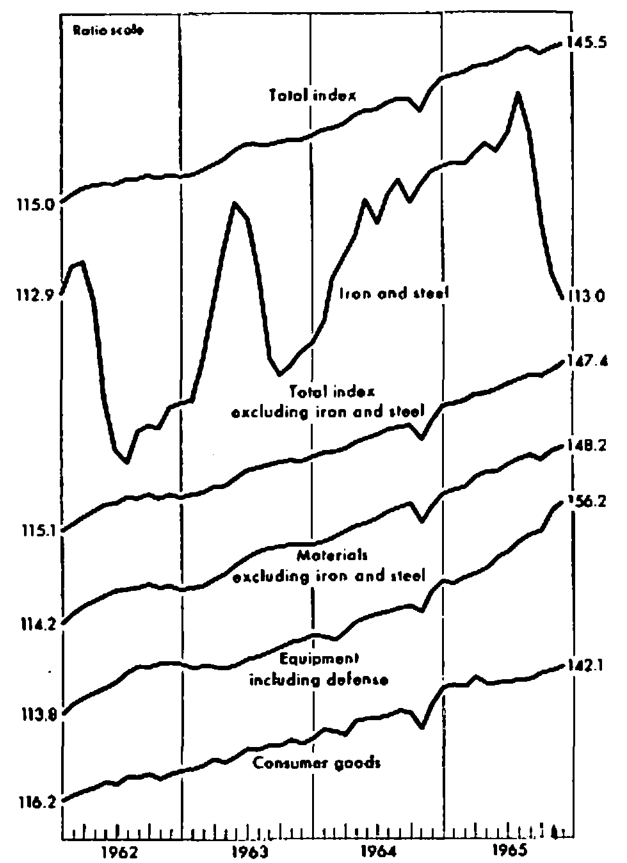
The continued momentum throughout the economy coupled with the many indications of strong future demand has heightened competition for the human and physical resources needed to meet current and expected future production schedules. As a result, price and wage restraints resulting from substantial margins of idle labor and capital have to a considerable extent been removed. The unemployment rate fell to 4.1 per cent in December, the lowest level in nine years. A substantial reduction in the unemployment rate is of course a most gratifying and important development, but it is also necessary to keep in mind that the current outlook for aggregate demand suggests a distinct danger of further intensified pressure on prices. Consumer prices moved up in November for the third consecutive month, but even larger increases were recorded at the wholesale level. The wholesale price index climbed 2.8 per cent for the year ended in November, with advances in almost every major category. The twelve-month increase in the industrial component of this index was the largest in a decade. Furthermore, the food component resumed its upward trend in November, and this was accompanied by accelerated increases in the prices of processed foods.

PRODUCTION, EMPLOYMENT, AND PERSONAL INCOME

Industrial output posted a broad gain in November, and the Federal Reserve Board's production index moved to a record level at 145.5 per cent of its 1957-59 average, despite a slight further decline in the iron and steel component (see Chart I). This moved the index 1.1 percentage points higher than the October figure, which had been revised upward, and slightly above the previous peak posted in August. Increases were widespread among final products and industrial materials (excluding iron and steel). Production of consumer goods, which had been sluggish during the first three quarters of the year, climbed for the second straight month. Gains for household appliances showed a substantial recovery from reduced summer levels, and auto assemblies through December continued strong at an annual rate of 9.3 million units. Output of equipment, advancing further after a large October increase, continued to reflect the sustained growth of business capital spending and the growing demand for defense equipment.

In December, steel output appears to have reversed the four-month downtrend that accompanied the liquidation of strike-hedge inventory built up in 1964 and early 1965. Preliminary figures indicate that last year's produc-

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



Source: Board of Governors of the Federal Reserve System.

tion probably reached an all-time high of roughly 130 million tons, topping by some 3 million tons the previous record established in 1964. The consensus of the trade is that any excess of inventories has been just about eliminated, and that steel consumption can be expected to grow further. New orders booked by steel mills for January and February show increases for a wide range of users, particularly among automobile companies. Incoming orders in all other durable goods industries as a group remained near their record high in November, despite substantial reductions in the typically volatile bookings received by the aerospace industry. Moreover, the level of unfilled orders advanced further even though shipments rose to an all-time high.

Nonfarm employment in December rose 367,000 to a record peak of 61.8 million persons, following an even larger gain in November. The latest figure, up 4.5 per cent from a year ago, is the biggest December-to-December advance in a decade. All major sectors except transportation and public utilities shared in the increase. Extensive use of overtime kept the average workweek clocked by manufacturing employees at the November figure of 41.4 hours, the highest level since October 1945. Despite increased overtime, economic momentum produced further tightening in the labor market. The number of labor market areas with "substantial labor surplus"—over 6 per cent—is down to 19, from 30 a year ago; the layoff rate is the lowest in twelve years; and the help wanted index in November advanced sharply once again. The need for additional skilled workers is reported to be particularly acute. The civilian labor force in December moved up to a new peak of 76.5 million, with the 4.1 per cent unemployment rate substantially below the 5.0 per cent registered only twelve months earlier. Unemployment rose slightly among teenagers, but significant declines were registered for both men and women over 20 years of age.

Total personal income in November posted one of the largest gains of the year, with higher wages and salaries accounting for two thirds of the advance. This upward movement brought the rate up to the record set in September, when income was swollen by a large retroactive social security payment. Reflecting both increased employment and a longer workweek, manufacturing payrolls showed a particularly sharp rise. All other forms of income including dividends, interest, and transfer payments also increased.

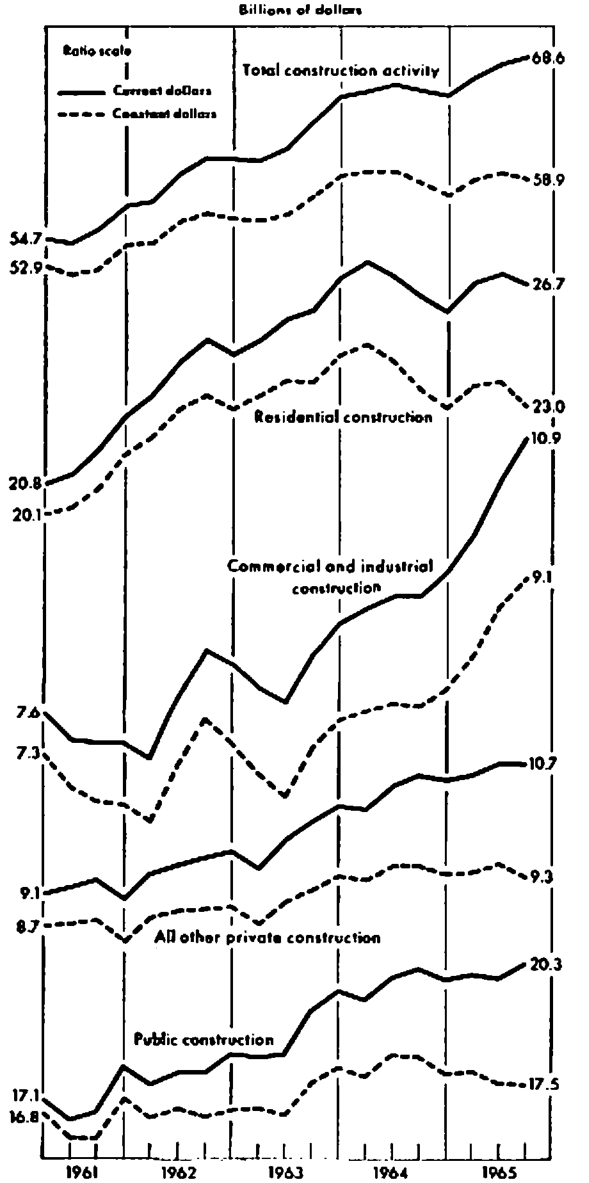
CONSTRUCTION ACTIVITY

Over the past several years, construction activity has been the one major sector in which real growth has lagged behind the pace of the over-all economic advance. This development actually may have aided the performance of other industries as relatively more resources have been available for expansion elsewhere. At the same time, price increases in this part of the economy have generally been more pronounced than elsewhere.

Total spending on new construction appears to have risen approximately 3 per cent during 1965 to a record of nearly $68 billion. But in constant (1957-59) dollars, which may be viewed as a rough indicator of changes in physical volume, building activity remained virtually unchanged. These aggregates, however, hide the fact that there were substantially different movements in the four major components of the construction industry. Thus, residential construction, i.e., private homes, was sluggish while commercial and industrial activity rose sharply (see Chart II).

The category "all other private construction"—including schools, churches, hospitals, farm buildings, and some utilities—as well as public construction advanced modestly when measured in current dollars while declining slightly in real terms (these categories are also shown in Chart II). Thus, virtually all of the $2 billion expansion in construction outlays in 1965, and about 45 per cent of the $14 billion advance during the past five years, represent price increases. In the residential sector, the downward movement of 1964 and 1965 is more marked when measured in constant dollars.

Chart II
CONSTRUCTION ACTIVITY
Quarterly totals at seasonally adjusted annual rates
Billions of dollars



Source: United States Department of Commerce.

The three most basic features characterizing the housing sector of the construction market since 1961 have been a comparatively stable demand for additional single-family homes, a generally growing demand for apartments, and a cycle in apartment construction resulting from considerable overbuilding in the early part of the period followed by many months of adjustment. The first two of these features largely reflect specific demographic forces, which may well continue to influence heavily the composition of residential construction activity in the near future. Although the total demand for housing is directly related to the rate of household formation and the demolition of existing structures, the type of housing that families seek is more closely associated with the age of the head of the household. According to patterns that have been indicated by a University of Michigan survey, less than one out of every six family heads under 24 years of age owned a home in 1964. This proportion rose to almost one half in the 25- to 34-year group, and to roughly three quarters in the 35- to 44-year category. (The percentage of homeownership remains virtually unchanged between 45 and 55 years and drops slightly for older groups.)

Thus, it appears that the largest additions to the demand for privately owned homes originate with the 25- to 44-year-old group, which is precisely the portion of the population that did not increase in size during the last five years. In fact, the number of people in the 30- to 39-year category actually declined. The largest population gains were among the 18- to 24-year-olds (reflecting the "baby boom" during and immediately following World War II) and among the aged—both groups in which rentals of apartments are the most typical way of making a home. It is not surprising, therefore, that the construction of apartments almost doubled as a percentage of housing starts from 1960 through 1964. Neither is it surprising that the suddenness of the surge in apartment demand led to overbuilding in some major metropolitan areas—especially in the Far West in the early 1960's—and to subsequent adjustments in 1964 and 1965. This pattern in apartment building was reinforced, in the case of New York City, by a construction speedup in 1962-63 in anticipation of the effective date of more stringent building codes, followed by two years of lower activity. It appears, however, that the excess in the supply of apartments has been reduced in at least a few major metropolitan areas and that, supported by the growing number of young adults and elderly people, some renewed expansion in this area can be expected. Both apartment- and house-building activity has been aided by the abundant supply of mortgage financing that has been available throughout the current five-year expansion.

The present age composition of the population indicates that the number of people entering the home-buying group will probably not increase rapidly enough to lift near-term demand for one- and two-family homes much above the plateau of the past few years. From the end of 1965 through 1970, for instance, the size of the 30- to 39-year-old group is expected to continue declining. Moreover, demolitions of existing housing, which primarily removed rental units in 1965, have been relatively constant over the last few years.

Industrial and commercial construction, on the other hand, have been advancing strongly since mid-1963. With over three quarters of 1965 accounted for, it appears that outlays moved up last year by an exceptionally large 15 per cent. The expansion, modernization, and relocation of manufacturing plants has been the primary source of this advance, but the building of stores, warehouses, and offices also moved ahead strongly in 1965. Moreover, the high rate of capital spending planned by business for the first half of 1966 suggests that activity in industrial and commercial construction will remain strong over the months ahead.

The category "other private construction" has been moving up steadily since early 1963. With the sole exception of the farm component, which has been experiencing a downtrend for at least the last decade, the country's growing and increasingly mobile population provides an underpinning for further moderate advances in this sector.

Public construction, measured in current dollars, advanced irregularly during the 1960's as a whole but showed significant strength in the closing months of 1965. Most of the subsections of this group—such as street and highway construction and sewage and water works—involve long-term programs and thus are fairly predictable. The current level of commitments indicates that in the year ahead further growth may approximate the same 6 per cent rate that has prevailed in 1963 and 1964. In real terms, however, public construction has trended downward during the past year and a half, and no major reversal seems likely in the immediate future.

Thus, it appears that trends in construction activity have been mixed, with nonresidential construction providing the only major source of strength. Within the residential component, there is some evidence of a recovery in apartment building, but the next major expansion in the demand for single-family homes does not appear likely in the immediate future.

PERSPECTIVE ON 1965

The Federal Reserve Bank of New York has just published *Perspective*, its annual nine-page review of economic and financial developments during the preceding year. This booklet is a brief and simplified summary of the highlights treated more fully in the Bank's *Annual Report* which will be available in mid-March. Copies of *Perspective on 1965* are available without charge from the Publications Section, Federal Reserve Bank of New York, 33 Liberty Street, New York, N. Y. 10045.