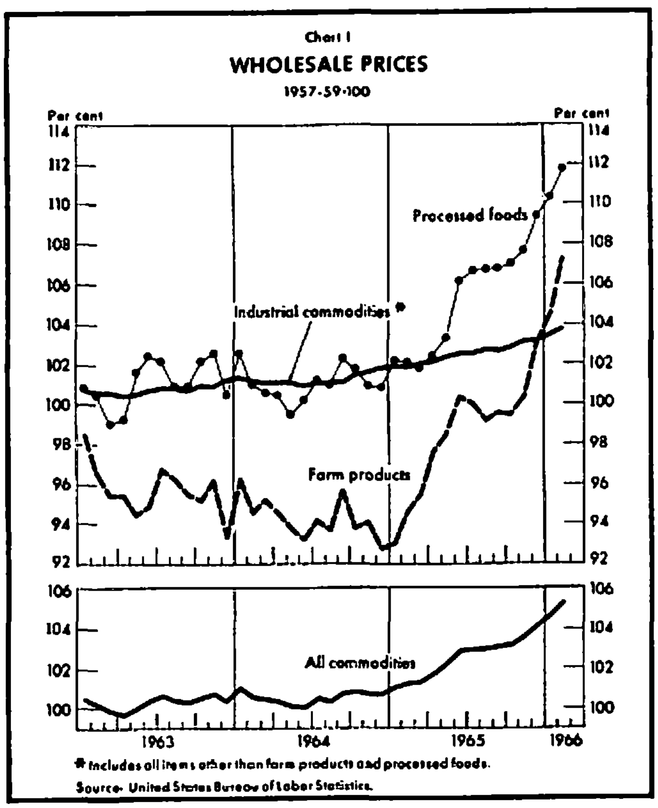
The Business Situation

The vigor of the domestic business expansion continues unabated. Indeed, the strength of economic activity during the opening months of the year has led to intensified pressures on the economy's resources of manpower and physical capacity. Conditions in the markets for labor have become tighter over all than at any time in more than ten years. Rates of capacity utilization have also risen significantly further in recent months, to around the highest levels since the Korean war. Current indications continue to point toward a further substantial growth in economic activity over the months ahead and to stepped-up demands upon available resources. Thus, for example, the results of the latest survey of business plans for capital investment point to another very strong rise in such outlays this year—a rise so strong, in fact, as to raise some question regarding the ability of capital goods producers to meet the indicated production requirements.



* Includes all items other than farm products and processed foods.
Source: United States Bureau of Labor Statistics.

In mid-March, Congress passed the tax legislation requested by the President in January. While helpful, these measures taken alone are unlikely to eliminate the continued upward pressure on wages, materials costs, and the selling prices of goods and services. Meanwhile, the over-all wholesale price level rose sharply once again in February, with the largest advances continuing to be centered in the agricultural sector where unusually bad weather curtailed supplies (see Chart I). During the past year, a combination of supply shortages and strong demand has put very heavy upward pressure on agricultural prices, but analysts expect that market conditions will be easier this year, and farm and food prices apparently did move somewhat lower in March. The rise in industrial wholesale prices, while much more moderate, has nevertheless persisted now for well over a year. In February, prices advanced for a broad range of individual products and the industrial price index rose at a substantial annual rate of about 3½ per cent, the same as in January and much ahead of the increase of roughly 1½ per cent recorded for the year 1965. At the consumer level, February witnessed modest price increases for a broad range of nonfood commodities, while the prices of services continued their steady advance and food prices registered an exceptionally sharp further increase. Largely as a result of this jump, the over-all consumer index rose by ½ per cent, reaching a level 2½ per cent higher than in February 1965.

PRODUCTION AND EMPLOYMENT

Industrial production expanded significantly further in February, as the Federal Reserve Board's seasonally adjusted index rose by 1.2 percentage points to 151.3 per cent of the 1957-59 average. The growth of output continued to be broadly based: over-all consumer goods production increased despite a modest further reduction in the automobile assembly rate, and there was another sizable advance in the output of defense equipment. Business equipment production, buoyed by the strong pace of capital spending, surged further and reached a level some 16½ per cent higher than in February 1965. The pace of activity in the steel industry moved up once again, contributing to an over-all rise in the output of materials. At the same time, an indication of further production gains over the near term was provided by the February volume of new orders for durable goods. The total orders flow expanded slightly to reach a new record, despite a sizable drop in new bookings in the defense-oriented industries—an orders component which tends to move quite erratically from month to month. Thus, new orders for civilian goods rose substantially in February, and the over-all backlog of unfilled durables orders grew once again.

In March, further gains in steel production were recorded amid industry reports of a continued strengthening in demand. On a seasonally adjusted basis, the March increase represented the fourth consecutive monthly advance, putting output almost 30 per cent above the October-November level, when industry production was at its lowest point in the readjustment period following the contract settlement. Automobile production also expanded in March, more than recouping the modest declines of the two preceding months. Indeed, the seasonally adjusted annual rate of new car assemblies in March, at 9.4 million units, was the highest since last summer. New car sales were at an annual rate of about 9.1 million units in February and March, and the production advance apparently reflects the buildup of new car inventories in preparation for the spring selling season.

Reflecting the brisk pace of economic activity, the demand for civilian workers has continued to expand in recent months. Although the growth of the total labor force in the first quarter was about equal to the large fourth-quarter gain, the growth of the civilian labor force slowed down somewhat as the expansion of the armed forces cut into the labor supply. The further tightening of civilian labor markets led to another substantial decline in the over-all unemployment rate, which averaged 3.8 per cent in the first quarter as compared with 4.2 per cent in the fourth quarter and 4.8 per cent in the first quarter of 1965. The rate in fact dropped to 3.7 per cent in February, but that low reading resulted partly from contraseasonal developments in the teen-age labor force, and in March the rate edged back to 3.8 per cent.

The recent trend of employment in nonfarm establishments provides further evidence of the heavy demands in the labor markets. The number of persons on the payrolls of such establishments has been growing this year at a very substantial pace—significantly faster than the monthly average for 1965 as a whole and not far below the exceptional rate of gain witnessed in the final months of 1965. The expansion of manufacturing employment has been particularly strong. At the same time, the average number of hours put in each week by manufacturing production workers has risen substantially, as employers have found it necessary to make increasing use of overtime. In both February and March, the workweek averaged 41.6 hours, the longest since World War II. The strong demand for labor in manufacturing is also reflected in the increasing willingness of workers to quit one job in favor of another: both the rate of voluntary quits per hundred employees in manufacturing and the rate of hirings have recently reached the highest levels since 1953.

BUSINESS INVESTMENT PLANS

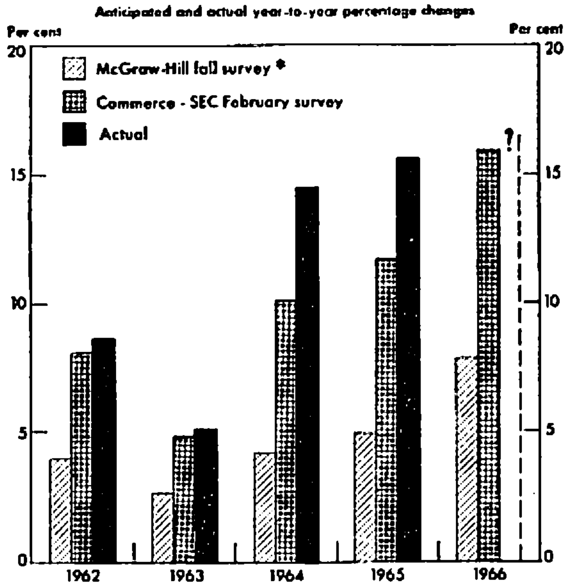
According to the latest Government survey of business plans for capital investment, the rate of spending on new plant and equipment will very likely continue to expand rapidly throughout 1966. The Commerce Department-Securities and Exchange Commission survey, taken in late January and February, found that businessmen plan to spend a total of $60¼ billion on new facilities this year. That figure represents a 16 per cent increase for the year as a whole, fractionally larger than the very substantial growth rate recorded in 1965 (see Chart II). The rate of advance, moreover, is expected to be about as rapid in the second half of the year as in the first half. This very strong showing for over-all investment reflects the buoyancy of spending programs in most of the individual industries. Manufacturers, taken altogether, reported that they plan to spend 19.2 per cent more than in 1965, just a bit under last year's 20.8 per cent gain. Outside of manufacturing, the indicated rise in capital spending this year is more rapid than last year, largely reflecting a planned increase in spending reported by firms in the communications-trade-service category.

Intensifying pressure on productive capacity throughout the economy is a major factor underlying the plans for a continued high rate of growth in plant and equipment spending. In the manufacturing sector, according to data gathered by McGraw-Hill, the over-all operating rate has increased appreciably since last fall and a number of industries are running in excess of their "preferred" rates. It is noteworthy that the manufacturing industries ranking first and second in terms of the planned percentage rise in capital spending—nonautomotive transportation equipment and textiles—had already exceeded their "preferred" rates by the end of 1965. The machinery producers, whose operating rates have reached or exceeded "preferred"

Chart II

PLANT AND EQUIPMENT SPENDING

Anticipated and actual year-to-year percentage changes



* Taken in the fall prior to the beginning of the year indicated.

Sources: United States Department of Commerce; Securities and Exchange Commission; McGraw-Hill, Inc.

levels in recent months, also rank near the top in terms of the planned percentage growth in spending. Manufacturers apparently see little prospect of any significant near-term reduction in demand pressures. Although productive capacity is now growing more rapidly than it did in the earlier years of this business expansion, expectations regarding sales growth are also more buoyant. According to the February Commerce-SEC survey, manufacturers' sales anticipations add up to an expected over-all gain of 8 per cent this year, compared with expected rises of 6 per cent reported by the comparable surveys in both 1965 and 1964. The actual sales gains were 8½ per cent in 1965 and 7 per cent in 1964.

In the past two years, business outlays for plant and equipment have substantially exceeded the volume indicated by the Government's February surveys of spending plans (see Chart II). The current prospects for a continued strong rate of growth in over-all economic activity at least suggest the possibility of a similar upgrading of expenditure programs during 1966. It is noteworthy, however, that the amount of upgrading in spending plans for the first half of 1966 between the Government's November and February surveys was much smaller than the upgrading between the comparable November and February surveys of the two previous years. Moreover capital investment projects this year are pressing more heavily on the economy's capacity to undertake them, and limitations of supply may well play a role in dampening any tendency toward still further expansions of 1966 investment plans. Some restraining influence may also be exerted by the increasing scarcity and the rising cost of capital funds, especially since it is generally expected that business will have to rely more heavily this year on external sources of financing. In this connection, it might be noted that the Government's February survey was taken prior to the latest increase in the prime lending rate at commercial banks. During the past month, moreover, the President has urged businessmen to consider whether they might cut back somewhat on their capital investment programs for 1966.

The investment plans most recently reported are certain to put intense pressure on the capital goods industries, even without any further upgrading. By the end of 1965, business fixed investment already accounted for a larger proportion of over-all gross national product than at any time since the investment boom of 1956-57. The proportion can be expected to move still higher this year since 1966 is likely to be the third consecutive year in which the growth rate of capital spending exceeds that of GNP. In marked contrast to the experience of a decade ago, the rate of increase in capital goods prices has thus far remained modest—though in recent months there has been evidence of some acceleration. In any event, the continued rapid growth of capital spending will likely put persistent upward pressure on such prices.