

The Business Situation

Business activity continues to expand and price pressures remain strong as the economy moves into late summer. Although the recent rate of the expansion has been less hectic than in the dangerously overexuberant first quarter, there are indications that activity may quicken in the second half of the year, intensifying the strains on the economy's productive resources. Thus, consumer spending over the balance of the year should be strengthened by Federal pay increases and by the beginning of Medicare payments, both of which became effective July 1. Moreover, capital spending by business could accelerate relative to the second-quarter rate of advance, unless strikes continue to hamper construction activity, as was apparently the case in the April-June period. Finally, spending at both the state and local and the Federal levels appears to be headed up strongly over the balance of the year.

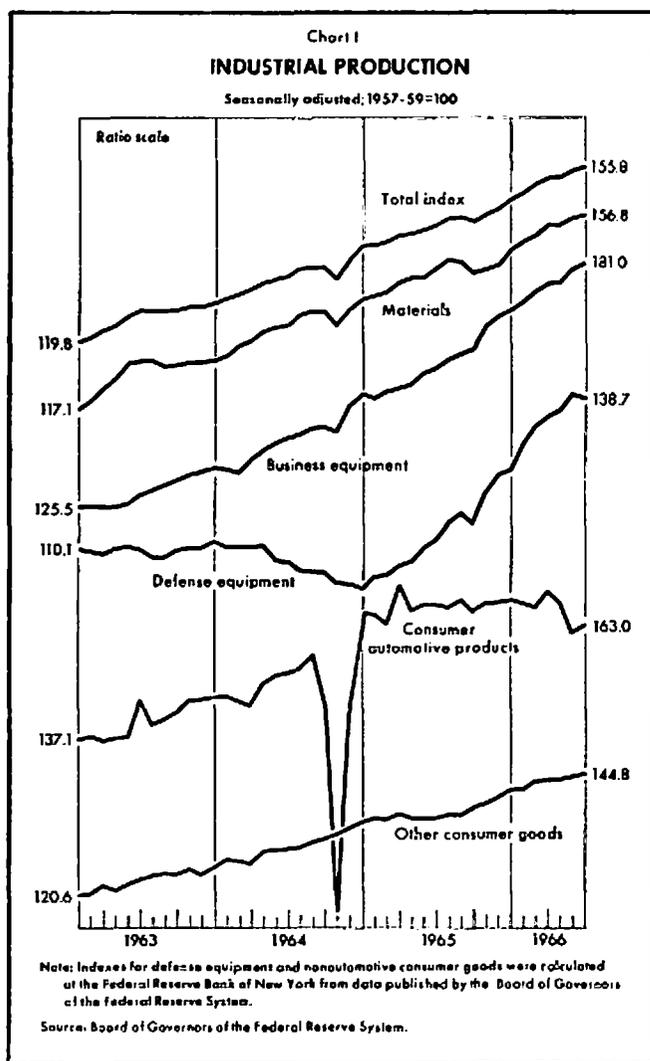
The second quarter ended on the more restrained note that had characterized April and May. While there were gains in industrial production and auto sales in June, as well as a sizable rise in payroll employment, developments in other areas were more mixed, with continued softness in residential construction and apparently some slight easing of intense labor market pressures. Newly released data on gross national product (GNP) in the second quarter indicate a substantial slowdown relative to the first three months of the year. Indeed, the April-June increase in GNP was the smallest for any quarter since the final three months of 1964, when there was a major strike in the auto industry. Analysis of the new figures, however, strongly suggests that special factors played a significant role in the second-quarter slowdown. Thus, as already noted, strikes apparently were a factor in restraining business outlays on factory construction. In addition, the relatively feeble rise in consumer spending, the most important single element in the overall deceleration, accompanied the smallest gain in after-tax personal incomes in three years. This de-

velopment, in turn, was attributable partly to the unusually heavy amount of final tax payments made by consumers in April and by the switch to the new graduated withholding system in May.

Even though the growth of demand moderated somewhat in the second quarter, the annual rate of increase in the prices of the goods and services included in GNP remained at the rapid 3.6 per cent first-quarter pace. Prices moved up again at both the wholesale and retail levels in June and may have advanced further in July. Over the first half of the year the consumer price index rose at a 3.4 per cent annual rate, compared with a 2.4 per cent rate over the same period last year. Similarly, industrial wholesale prices increased at a 3.3 per cent annual rate, as against only 1.4 per cent in the first six months of 1965. There is every prospect that demand pressures on prices will persist. Moreover, "cost push" factors may well become increasingly important in determining price behavior, particularly when the heavy round of wage negotiations begins about the turn of the year.

PRODUCTION, ORDERS, AND EMPLOYMENT

A further advance in industrial output during June boosted the Federal Reserve Board's seasonally adjusted production index by 0.8 percentage point to 155.8 per cent of the 1957-59 average (see Chart 1). Though production had increased by a somewhat larger amount in May, when output rebounded from the effects of coal-mining and railroad strikes, the latest rise was still equal to the average of the preceding two months. With the exception of a small decline in the output of defense products, following sustained large gains over the past year, all major industry sectors shared in the June advance. For the second quarter as a whole, overall production rose



at an annual rate of nearly 8 per cent, considerably below the first-quarter growth but right in line with the strong rate of gain for all of 1965.

Reflecting the reduced rate of new-car sales in the second quarter and the record high level of dealer inventories, automobile assemblies were cut back sharply to a seasonally adjusted annual rate of 7.7 million units in July, down slightly less than 10 per cent from June. By the end of July, virtually all production of 1966 models had been terminated. Although a few plants are already at work turning out 1967 cars, most car makers apparently plan a somewhat longer changeover period than usual in order to allow their dealers time to reduce the record carry-over of 1966 models.

Other available indicators of July industrial activity

point to advances in output. Thus electric power production increased sharply on a seasonally adjusted basis, partly reflecting the very high temperatures prevailing over wide areas of the country. In addition, steel ingot production rose by roughly 1.2 per cent to an annual rate of around 140 million tons (seasonally adjusted), just below this year's high set in April. The sustained boom in capital spending is reported to be the major source of buoyancy in steel demand, and industry observers point to the large backlogs of orders on the books of capital goods producers as indicating a strong future demand for steel. Indeed, the record high level of unfilled orders of durables manufacturers as a group supports the outlook for overall production increases over the near term. While the incoming flow of new orders received by these manufacturers was largely unchanged in June, such orders continued to exceed the shipments rate by a wide margin. As a result, the backlog of durable orders rose by a very large 2.1 per cent in June, bringing the total advance in backlogs to over \$8.5 billion in the first six months of the year or roughly equal to the gain for all of 1965.

More than 800,000 people entered the civilian labor force in June (on a seasonally adjusted basis), reflecting a sizable influx of teen-agers into the job market as well as the addition of a substantial number of adult women. This exceptionally large increase in the labor force was mostly absorbed by the expanding economy, and the total number of people employed rose sharply. In nonagricultural industries, payroll employment increased by nearly as much as the rapid average monthly gains recorded in the first quarter of the year, thus reversing some of the weakness in April and May. Advances were registered in all major categories, including the construction industry where employment had been affected by strikes in several areas of the nation.

The overall unemployment rate remained at 4 per cent in June, as a decline in the unemployment rates for both teen-agers and adult women offset a slight rise in the unemployment rate for adult men. For the second quarter as a whole, the average overall unemployment rate edged higher by 0.1 percentage point to 3.9 per cent. More significantly, this slight lessening of pressures in the labor market was also reflected by some shortening during the second quarter in the average length of the workweek and in the number of overtime hours worked.

GROSS NATIONAL PRODUCT IN THE SECOND QUARTER

The nation's total output of goods and services (measured at a seasonally adjusted annual rate) rose by \$10.8

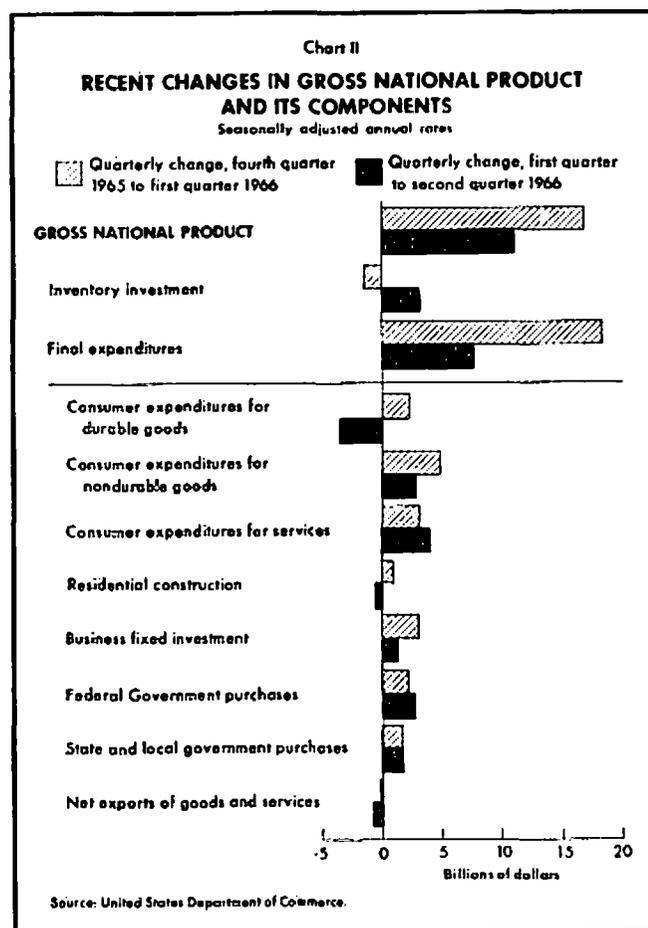
billion in the second quarter to a level of \$732.0 billion, according to the Commerce Department's preliminary estimates (see Chart II).¹ This advance was considerably more moderate than in the two preceding quarters, when the largest dollar gains of the entire postwar period were registered. At the same time, however, the average price of output rose at the first-quarter rate of 3.6 per cent, sharply faster than the 1.8 per cent average increase in 1965. Thus, the annual rate of increase in real output in the second quarter slowed to 2.3 per cent, markedly below the 5.9 per cent rate of gain recorded in the opening three months of the year and in all of 1965. Since the growth of industrial production was still relatively fast, however, the slower rate of expansion of real GNP does not appear to reflect significant limitations on industrial capacity.

One major factor holding down the expansion in total expenditures during the latest quarter was a notable reduction in the growth of consumer demand, following the rapid gains registered in recent quarters. The slump in automobile sales was, of course, the main feature of the slower rate of gain in consumer spending. Consumer purchases of other durable goods, however, also declined slightly, while expenditures on nondurable goods expanded only moderately. Outlays for services, in contrast, showed the largest quarterly rise in the postwar period, due in part to the very sharp run-up in prices of services during the April-June period.

The weakening in consumer demand during the second quarter in large measure reflected the reduced growth of disposable income; the proportion of disposable income saved remained virtually unchanged from the first quarter. The speedup in withheld personal income taxes, effective May 1, cut some \$800 million (annual rate) from the second-quarter growth of disposable income. Final payments of 1965 personal income taxes in April also put a drag on after-tax income growth, amounting to about \$1.6 billion at an annual rate. With the beginning of the current quarter, however, disposable income received a substantial boost as a result of the pay raise for Federal Government civilian and military personnel together with the inauguration of the Medicare program. The combined effect on incomes of these two factors may amount to some \$4.0

billion at an annual rate and should provide considerable stimulus to consumer spending. In July, new-car sales were roughly unchanged from the 8.3 million units (seasonally adjusted annual rate) sold in June, after having averaged 7.6 million in April and May.

The second-quarter decline in automobile sales was accompanied by a sharp rise in dealer inventories of new cars and was thus a major factor in the unusually sizable buildup of total business inventories during the quarter. Net additions to inventories amounted to \$12 billion at a seasonally adjusted annual rate, the largest for any quarter in over fifteen years and \$3.1 billion more than in the first quarter of this year. In addition to the expansion in automobile inventories, there were especially rapid inventory gains in the machinery and aircraft industries where production has been rising sharply. Over the near term, aggregate inventory investment will be restrained by the efforts of auto dealers to work down their



¹ The Commerce Department's usual midyear revisions of the national income and product accounts had the effect of raising GNP by \$1.3 billion in 1963, \$3.0 billion in 1964, and \$4.9 billion in 1965. For the first quarter of 1966, GNP was revised upward by \$7.3 billion to a level of \$721.2 billion; however, the revision had virtually no effect on the size of the rise in GNP from 1965-IV to 1966-I.

huge supply of new cars. Businessmen in other key industries, however, have generally continued to keep a tight rein on their inventory positions, as evidenced by conservative inventory-sales ratios.

Business investment in fixed capital expanded by \$1.3 billion in the second quarter, maintaining the ratio of such expenditures to GNP at the 10.7 per cent first-quarter level—the highest in the postwar period. This second-quarter gain in capital spending was only about half as large as the advance registered in the previous quarter, however, and appeared to fall below the increase called for by the latest Government survey of capital spending plans. The slower growth of investment outlays may have partly reflected the combined effects of supply bottlenecks, skilled labor shortages, and the higher cost and reduced availability of funds. More importantly, however, work stoppages in the construction industry probably had a significant depressing influence, as business outlays for new and modernized structures actually declined from the first-quarter level. Additional expenditures for business equipment, in contrast, were substantially larger than the gain posted for the first quarter of the year.

In the government sector, state and local spending for goods and services rose by \$1.7 billion for the second consecutive quarter, thus staying within the range of advances

recorded in the past few years. At the Federal level, purchases increased by \$2.7 billion in the second quarter, equal to the largest previous gain recorded in this business expansion. The bulk of the second-quarter rise again reflected stepped-up spending for national defense purposes; nondefense outlays increased somewhat less than the average gains registered in recent quarters.

Among other major components of national output, expenditures for residential construction declined slightly in the second quarter, bringing the rate of such spending back to the year-ago figure. Moreover, current indicators of prospective home-building activity point to some further slackening in the months ahead. Thus, nonfarm housing starts during the second quarter averaged about 10 per cent below the first quarter and were at the lowest rate in five years. Similarly, newly issued building permits fell 13 per cent in the second quarter, reaching the lowest level since 1958.

Net exports of goods and services declined for the fourth consecutive quarter, dropping to \$5.3 billion—the smallest margin of exports over imports since the opening quarter of 1963. The sharp reduction this year of the export surplus has been a serious obstacle to the solution of our balance-of-payments problem and reflects the exuberance of the domestic economy as well as the conflict in Vietnam.