The Business Situation

Business developments during the past month were overshadowed by announcements of several measures intended to restrain inflationary pressures in the economy, and to alleviate the strains in the nation's credit markets. Meanwhile, the economy continued to advance along a broad front and demand pressures remained excessive. Moreover, there were indications that the threat of upward price pressures arising from labor cost increases in excess of productivity growth was intensifying.

In a policy statement issued September 1, the Federal Reserve System urged a moderation in the rate of bank loan expansion, and particularly in the expansion of business loans.[1] The statement, while reminding financial markets that the Reserve Banks' "discount windows" are available as always to meet seasonal or unusual strains, observed that "the aggregate total of credit-financed business spending has tended towards unsustainable levels and has added appreciably to current inflationary pressures". It went on to note that exceedingly rapid growth of bank credit to business could contribute to strains in other sectors of the credit markets.

A week later, the President asked Congress to suspend certain tax benefits applicable to business capital investment, indicating that such action was desirable in order to relieve excessive pressures on capital goods producers as well as on the financial markets. Moreover, the President stated that he intends to cut back "lower-priority" Federal expenditures by some $3 billion, and he warned that additional fiscal actions might be needed to prevent imbalances in the domestic economy and to offset further growth in defense outlays. Though there is a great deal of uncertainty about the magnitude of future military requirements, it is now expected that the growth of defense outlays during the second half of 1966 will run considerably ahead of the quarterly advance of $2 billion (annual rate) that was incorporated into most projections made early in the year.

In a further action taken during September, new interest rate ceilings for various types of time and savings deposits were established late in the month by the Federal Reserve Board and other regulatory bodies, acting under powers newly granted to them.[2] These ceilings are intended to limit the further escalation of interest rates by institutions competing for consumer savings.

Although the overall economy has been buoyant, the scarcity of mortgage credit—coming in the wake of adjustments to earlier overbuilding—has had a depressing effect on home-building activity. The rate of housing starts declined sharply from March through July and then was about unchanged in August—at a level nearly one-third lower than the pace in the late winter. It is possible that the various measures taken and proposed during the past month will expand the supply of mortgage credit, which could improve the outlook for residential construction.

With respect to business capital spending, considerable time will probably have to pass before the proposed tax measures have any substantial impact on the rate of outlays. However, the President's tax proposals, coupled with the other measures taken during the past month, may have served to dampen inflationary expectations. Such expectations have been fed by the persistent rise in prices, particularly at the consumer level where the price index advanced sharply once again in August. Despite the fact that nonfood commodity prices were unchanged on balance, the overall consumer price index rose by one half of a percentage point, to 113.8 per cent of the 1957-59 average. Food prices showed an exceptionally large increase, while the prices of services continued to rise at the substantial rate of previous months. At the wholesale level as well, food prices registered a further sharp rise in Au-

[1] See this *Review* (September 1966), page 209, for the full text of the statement.

[2] For details regarding these rate ceilings, see this *Review* (October 1966), footnote 2 on page 221.

At the same time, Congress raised to 10 per cent, from the previous 6 per cent, the maximum reserve requirements that the Federal Reserve is authorized to establish for commercial bank time and savings deposits.

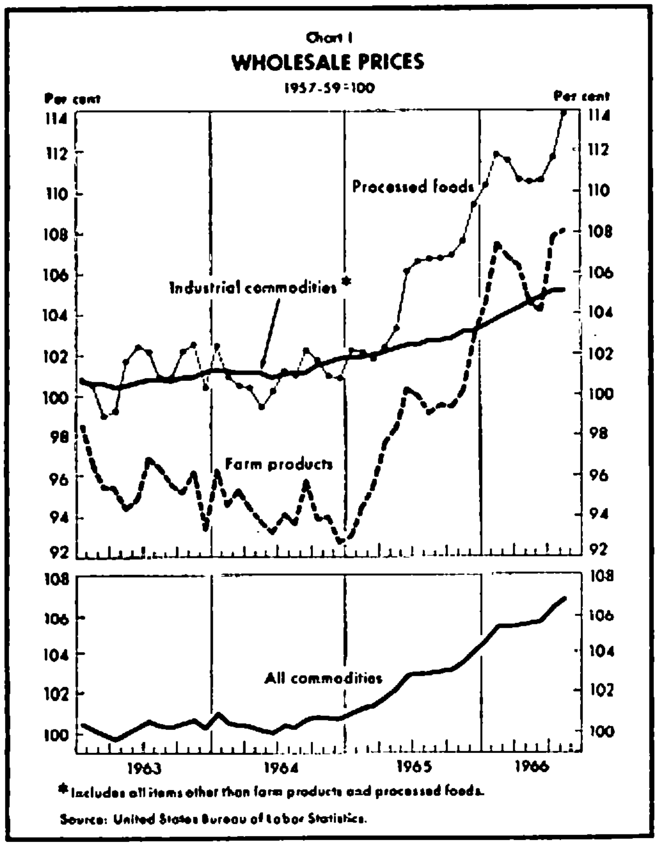

Chart I
WHOLESALE PRICES
1957-59=100

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

gust (see Chart I). As a result of price declines for various industrial raw materials, however, the overall industrial price level was unchanged in August. Partial information on wholesale prices in September indicates that agricultural prices rose once again while the industrial index appears to have remained stable.

BUSINESS INVESTMENT

The emphasis on business capital spending in the policy measures announced during September in part reflects the very rapid growth of such expenditures over the last three years. The latest Commerce Department-Securities and Exchange Commission survey of business capital spending plans—taken in August, prior to the President's request for legislation suspending the investment tax credit and accelerated depreciation allowances—confirmed the earlier indications that 1966 would witness another very strong advance in business outlays for new plant and equipment (see Chart II). If business spending plans for the remainder of this year attain the level anticipated in the August survey, total outlays in 1966 will amount to $61 billion, representing an advance of 17 per cent over the 1965 figure. An increase of that magnitude would be well ahead of last year's 15½ per cent gain, and would make this the fifth consecutive year of capital spending growth.

According to the Commerce-SEC survey, spending in the fourth quarter is expected to reach an annual rate of $63½ billion (seasonally adjusted), more than 50 per cent greater than the spending rate in the final quarter of 1963—only three years previously. The very strong growth of demand for new facilities during the past several years has put increasing pressure on the productive capacity of capital goods producers and of certain sectors of the construction industry. Evidence of such pressures has been seen in labor shortages, delivery delays, increased backlogs of orders, mounting imports, and rising prices. During the past year, moreover, credit to finance investment projects has become increasingly scarce and its cost has risen. In these circumstances, it is perhaps not surprising that business plans for capital spending in the second half of 1966, as reported in August, were virtually identical to those indicated by the previous survey in May—in contrast to the pattern of the past few years when upward

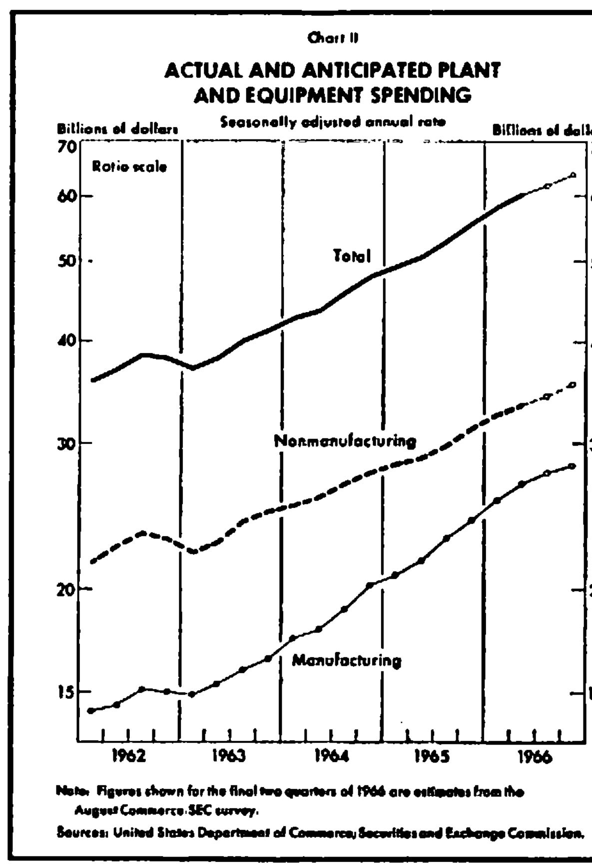

Chart II
ACTUAL AND ANTICIPATED PLANT AND EQUIPMENT SPENDING

Note: Figures shown for the final two quarters of 1966 are estimates from the August Commerce-SEC survey.
Sources: United States Department of Commerce; Securities and Exchange Commission.

revisions were almost invariably reported by each successive survey. The restraining effects of supply problems coupled with credit tightness are helping to limit 1966 investment programs to the exceptionally high level already projected in May.

It is very difficult to estimate the effects on capital spending that might result from a suspension of the 7 per cent investment tax credit and accelerated depreciation allowances. Over the near term, the volume of capital spending would probably be little affected, since projects already under way would almost certainly be completed. However, spending in 1967 would be reduced to the extent that businessmen decide to cancel some investment programs—or, as is more likely, to postpone or stretch them out. It could be expected that the suspension of the investment tax credit would have a more immediate impact on the volume of new orders received by the capital goods industries. To be sure, ever since spring the total volume of durables new orders has shown little buoyancy, but this moderation has been largely concentrated in industries other than those oriented to capital goods production. A slowing of the order inflow to capital goods producers would moderate the growth of their unfilled order backlogs and might well enable them to work down some part of the very large backlogs now on their books. It would be a welcome development if such an orders slowdown were to lead to some reduction in the currently intense pressures on capacity and labor resources in the capital goods industries. Even if the production rate in those industries were not appreciably affected, a slowing of new orders and moderation of backlog growth might be expected to result in an atmosphere less conducive to price increases. On the other hand, a significant slowing of business fixed investment would have a dampening effect on productivity growth.

At the same time that spending for fixed capital investment has expanded vigorously, manufacturers have substantially increased their investment in inventories. Since early this year, durables producers have made progressively larger monthly additions to their inventories, and the ratio of inventories to sales in that sector has risen noticeably. Nondurables manufacturers have also been expanding their stocks at a rate generally more rapid than previously, but their stock-sales ratio has remained at about the low level reached last year. During the second quarter, according to the Commerce Department's August quarterly survey of inventory and sales expectations, both durables and nondurables manufacturers reported an appreciable advance in the proportion of inventory evaluated as "high" relative to sales and unfilled orders. Durables manufacturers reported the highest such percentage of the current expansion, except for the reading in September 1965 when strike-hedge steel stockpiles were at a peak.

According to the August expectations survey, third-quarter accumulation by durables producers was running well ahead of the pace projected last May. In the fourth quarter, however, the growth of durables inventories is expected to slow sharply. Though actual inventory investment by durables producers in the past two years has generally exceeded the anticipations reported in the quarterly surveys, the expectation of a substantial drop in the accumulation rate in the fourth quarter may nevertheless reflect a degree of caution in inventory policy. When coupled with their sales forecasts, the durables producers' inventory anticipations point to a modest decline in their inventory-sales ratio by year-end.

PRODUCTION, INCOME, AND CONSUMER DEMAND

Continued substantial growth of output in most industrial categories carried the Federal Reserve's production index (seasonally adjusted) up by a further nine tenths of a percentage point in August, to 158.3 per cent of the 1957-59 average. Automobile output registered a further sharp decline in August, but overall production outside the motor vehicle industry continued to expand at the substantial June-July pace. Once again, the strongest output gains were centered in the equipment industries, reflecting the sustained high rate of growth in demand for capital goods as well as for military hardware. Production of industrial materials also grew appreciably in August, despite a drop in steel output and a lack of buoyancy in construction materials output that apparently reflected the recent decline in home building. With the exception of automobiles, production in consumer goods industries continued to expand moderately in August.

Even after a seasonal adjustment that made a rough allowance for the production slack during the annual model changeover, automobile output declined in August by a further 6½ per cent to a seasonally adjusted annual rate of about 7¼ million units. Temporary problems apparently hindered the start-up of new-model production, with the result that the month's assembly schedules were not fulfilled. By early September, all assembly plants were in full operation turning out the 1967 models in preparation for their sales introduction at month end. Though production continued to fall somewhat below scheduled volume during the first half of the month, full September output resulted in a substantial advance in the seasonally adjusted assembly rate. A further rise is indicated by October production schedules.

The weakening of auto production in the spring and summer months had some dampening effect on activity in the steel industry. Though other sources of steel demand have reportedly shown steady strength, with growing defense requirements apparently taking up some of the auto slack, ingot production (seasonally adjusted) moved gradually lower during the late spring and summer months. In September, however, steel production registered a slightly more-than-seasonal rise, amounting to a seasonally adjusted gain of about 1½ per cent.

August witnessed a rather sharp drop in the volume of new orders received by durables producers. Part of the August decline apparently reflected the return, following a sharp July spurt, to a more normal level of orders for "miscellaneous transportation equipment" (which includes such items as vessels and railroad equipment). Aircraft orders, which are generally volatile, also dropped in August. Outside the transportation equipment industries, a reduced orders volume was also reported by producers of steel and electrical equipment. On the other hand, there was a sizable advance in the bookings of nonelectrical machinery producers, whose operations are largely oriented toward capital goods production. The August decline in aggregate new orders for durables brought them to a level not far above the volume of shipments. As a result, the further rise in the overall backlog of unfilled durables orders was relatively modest by comparison with the very high rates of growth in the earlier months of the year. Nevertheless, the backlog of durables orders at the end of August was fully 25 per cent larger than it had been a year earlier, and was equal to 3.2 months of shipments, up from a figure of 2.7 months in August 1965.

Reflecting the persistent growth of output in the equipment industries, the expansion of manufacturing employment in August was especially strong in those durables industries oriented to production of capital goods and defense equipment. In turn, the expansion of wage payments in those industries contributed substantially to the August rise in total personal income. The overall income advance was the largest of the year, owing to a sharp boost provided by social security medical care payments. The jump in these payments reflected the fact that August was the first month in which Medicare payments were made in any significant amount. Once the program has passed through its initial months and is in full operation, such payments can be generally expected to show only modest changes from month to month. In contrast to the sharp boost provided to income growth in August by the start of sizable Medicare payments, income growth this year had previously been dampened by rises in the level of social security contributions—in January, when the contributions tax rate was raised, and in July, when premium payments for voluntary medical insurance were begun.

The recent uptrend in sales volume at retail stores continued in August, as a strong advance carried that month's total past the record high established in March. Sales at stores concentrating in nondurables, which have moved steadily upward this year, registered a sizable further advance in August with increases reported in most lines of trade. A further recovery in automotive dealers' sales also contributed appreciably to the overall gain, though such sales remained below the peak reached prior to the April-May slump. Aggregate sales volume at all other durables outlets was about unchanged in August, and similarly remained below the early spring peak.

The sales performance of new domestically built cars was quite strong in the closing months of the 1966 model year, registering a seasonally adjusted annual rate of about 8½ million units in August and close to 9 million in September. The largely successful closeout of the old models provided a generally optimistic atmosphere for the introduction of the new models in the final days of September. Industry spokesmen reportedly look for sales of the 1967 models to be about equal to the 1966 model total of approximately 8½ million units, provided that orderly economic expansion and a high degree of consumer confidence are maintained. It is still too early to gauge the strength of consumer response to the 1967 cars, however, and the future trend of auto sales remains a major element of uncertainty in the outlook for consumer spending.