The Business Situation

Heavily influenced by rising defense expenditures, the business expansion accelerated during the third quarter, but the rate of growth remained below the hectic pace that had characterized the opening months of 1966. A few measures of business activity—generally those that had undergone especially sharp rises in earlier months—even paused toward the end of the quarter, while construction expenditures continued to decline. Nevertheless, aggregate demand remains excessive, cost pressures are strong, and the presence of inflationary forces continues to pose a threat to the economy.

Gross national product (GNP) showed a substantial advance during the third quarter. The main impetus was supplied by defense expenditures, business purchases of machinery and equipment, and personal consumption. The quarter's strong performance was again accompanied by substantial price advances, but at a rate below first- and second-quarter experience. The overall improvement in the behavior of prices was also reflected in the near stability of industrial wholesale prices in the last two months of the quarter as well as in October. The outlook for prices, however, remains disquieting in view of the continued heavy pressure on resources and of the accelerating trend toward higher labor costs that has resulted in part from the substantial increases in the cost of living since late 1965. The shortage of skilled labor shows no sign of abating. Although the rise in both industrial production and retail sales was interrupted in September, their quarterly advances were strong and there is little evidence of an underlying change in the uptrend. Moreover, new orders for durable goods rebounded sharply in September, reaching a new record and pushing the volume of unfilled orders still higher, while consumers experienced a further strong increase in disposable personal incomes.

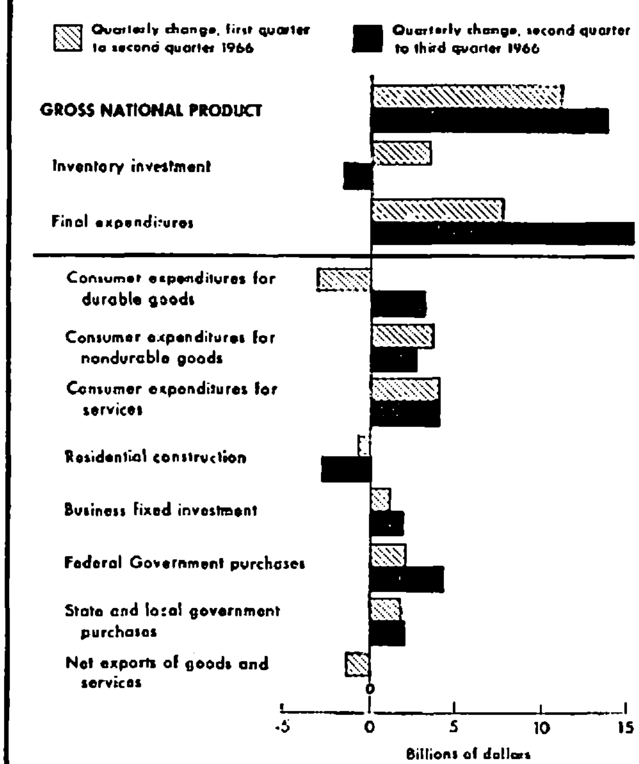
GROSS NATIONAL PRODUCT IN THE THIRD QUARTER

The nation's output of goods and services, according to the preliminary estimates of the Department of Commerce, rose by $13.7 billion during the third quarter (see Chart I), reaching a seasonally adjusted annual rate of $746.0 billion. This advance, amounting to an annual growth rate of 7½ per cent, was approximately halfway between the very high 9½ per cent rate recorded in the first quarter and the lower second-quarter gain of 6¼ per cent, and was roughly in line with the average growth experienced throughout the present expansion. More than one third of the latest quarter's increase in the dollar value of GNP, however, merely represented higher prices rather than real growth. Indeed, the implicit GNP deflator—the broadest measure of price trends in the economy—rose at

Chart I

RECENT CHANGES IN GROSS NATIONAL PRODUCT AND ITS COMPONENTS

Seasonally adjusted annual rates



Source: United States Department of Commerce.

an annual rate of 2.8 per cent. Although this rate of price increase was substantially lower than that recorded in the first and second quarters of 1966, it was nevertheless the highest rate for any other quarter since early 1958. Measured in real terms—that is, excluding the effects of price rises—output expanded in the third quarter at a 4½ per cent annual rate, as against 6 per cent and 2 per cent gains in the first and second quarters, respectively. The main features of the third quarter's increase in current-dollar GNP included an upsurge in defense expenditures, a large rise in personal consumption, and a further increase in business purchases of machinery and equipment, which was partly offset by a substantial decline in construction outlays.

Defense expenditures jumped by $4.2 billion in the third quarter of the year, reaching an annual rate of $61.3 billion or more than $10 billion higher than a year ago. The third-quarter upsurge in defense expenditures accounted for almost one third of the quarter's rise in GNP, thus underlining the impact of the war in Vietnam on the economy. At the same time, Federal spending for nondefense goods and services increased on balance only slightly, and the total increase in Federal spending on goods and services was held to $4.3 billion. State and local government purchases of goods and services, on the other hand, rose by $2.0 billion, substantially more than the average increases of the past few years.

The faster rise in personal consumption expenditures, following the modest second-quarter advance, had been expected because of improved trends in disposable income. During the second quarter, the growth in disposable personal income had been held down by large Federal income tax payments, arising primarily from the higher tax-withholding rates that began in May but also from the unusually large final payments in April of remaining 1965 tax liabilities. During the third quarter, on the other hand, disposable income was boosted by pay raises for Federal Government civilian and military personnel as well as by the start of the Medicare program. Largely as a result of these factors, disposable personal income increased by $7.4 billion in the third quarter, a gain more than 50 per cent larger than in the second quarter. Consumer spending rose even more strongly than disposable income, however—by $9.9 billion, as against a $4.5 billion gain in the second quarter. Expenditures for durable goods, which had declined in the second quarter (see Chart I) because of the fall in automobile sales, advanced sharply in the third quarter, with automobiles and parts accounting for roughly half of the increase. Consumer outlays for services rose by about as much as in the second quarter, while those for nondurable goods rose somewhat less.

Business fixed investment expanded by $1.8 billion in the third quarter of the year. This was an appreciably larger increase than that of the second quarter, but nonetheless remained below the quarterly gains recorded from the summer of 1965 to the spring of 1966. While the growth of investment in producers' durable equipment, at $2.4 billion, was the second highest for any quarter of this expansion, spending for nonresidential structures declined for the second consecutive quarter by $0.6 billion.

At the same time, total business spending for additional inventories, at $10.8 billion, was somewhat less in the third quarter than in the second. The $12.3 billion second-quarter spending increase, however, had been inflated by the rise in stocks of new automobiles in the hands of dealers that accompanied the decline of retail automobile sales. In the third quarter, on the other hand, dealer automobile inventories were reduced. Outside the automotive category, inventory accumulation was strong in the third quarter, reflecting in good part a buildup in durables manufacturers' investment in work in process. There was a marked slowing down during the quarter in the rate at which manufacturers increased their inventories, but even so the September accumulations remained very high.

Residential construction continued as a major weak spot in the economy. Total expenditures for this purpose, after declining by $0.6 billion in the second quarter, fell by another $2.8 billion in the third quarter. This development, which had been expected because of the preceding sharp decline in housing starts, provided some offset to the spending gains in other areas of economic activity. While housing starts remained stable in August and September following the earlier sharp declines—thus suggesting that the downtrend in residential construction might soon bottom out—fresh uncertainties for this industry have developed out of recent legislation, temporarily suspending the applicability of accelerated depreciation on new apartments (and other buildings) costing more than $50,000.

After having dropped in each of the preceding four quarters, net exports of goods and services remained unchanged in the third quarter, as both imports and exports rose by substantial amounts. At $4.7 billion, however, net exports are at their lowest rate in three and one-half years, and this depressed level has seriously impaired the efforts to improve this country's balance-of-payments position.

PRODUCTION, PRICES, AND EMPLOYMENT

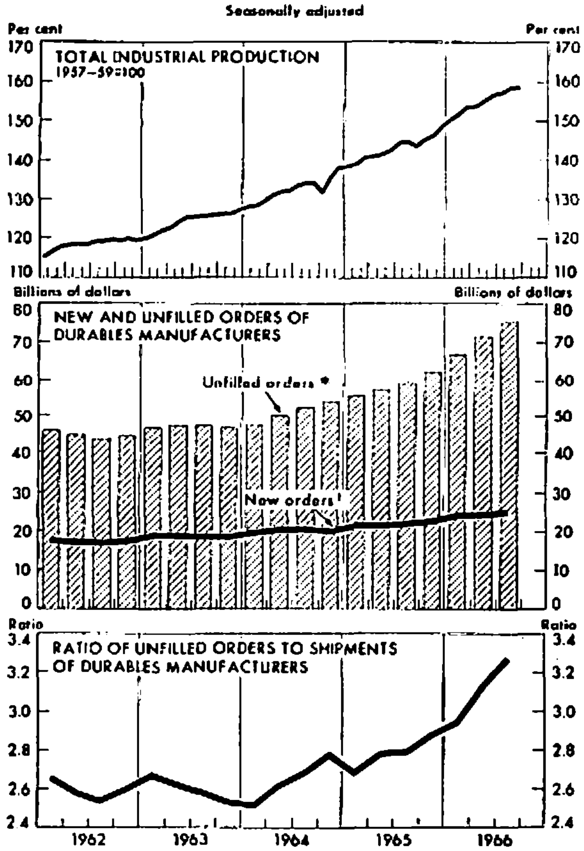
September witnessed a pause in the growth of industrial output, as the Federal Reserve Board's seasonally adjusted production index declined by 0.1 percentage point to 158.2 per cent of the 1957-59 average (see Chart II).

For the third quarter as a whole, however, industrial output expanded at an annual rate of 7 per cent—a slower but more sustainable pace than that reached earlier in the year, and one more closely in line with the growth rates experienced throughout most of 1965. The virtual stability of total industrial production in September resulted from steadiness in most of the index's major components. Automobile production, however, advanced substantially from the depressed level of the preceding month. The output of business equipment, reflecting the continuation of heavy investment outlays, was also up for the month, while defense production similarly continued to rise. Steel production, on the other hand, declined for the second consecutive month but still remained close to record levels.

Chart II

INDICATORS OF BUSINESS ACTIVITY

Seasonally adjusted



* End-of-quarter data.

† Quarterly averages of monthly data.

Sources: Board of Governors of the Federal Reserve System; United States Department of Commerce.

New orders received by manufacturers of durable goods rose by an almost unprecedented $1.7 billion (seasonally adjusted) in September, thus much more than recouping the decline registered in the preceding month. The volume of new orders received during the whole third quarter thus fully equaled the record established in the preceding quarter (see Chart II). As shipments did not rise perceptibly, the backlog of unfilled orders rose to a new high. At the end of September, unfilled orders on the books of durables manufacturers totaled $75.6 billion (seasonally adjusted)—a $2.3 billion increase over August and the equivalent of three and one-third months of shipments at present rates (see Chart II).

On the demand side, consumers have continued to provide important support for the economy's growth. While retail sales (seasonally adjusted) declined slightly in September, according to preliminary data, this followed a strong performance in August, when retail sales volume achieved one of its biggest monthly advances of the year. For the entire third quarter, retail sales grew at an annual rate of close to 10 per cent, or at roughly the same rapid pace as in the first half of the year. At the same time, personal income continued to grow strongly, increasing by $4.1 billion in September. Despite the present tight monetary conditions, the availability of consumer credit appears by and large to have been maintained by banks and other primary lenders. To be sure, the September rise in consumer credit outstanding was the smallest in almost two years, as new instalment credit extensions declined by 1.7 per cent (seasonally adjusted). These extensions, however, remained at a very high level by historical standards, and only four months, all in 1966, exceeded the September reading. For the third quarter as a whole, consumer instalment credit extended was 7 per cent (annual rate) higher than in the second quarter, while consumer credit outstanding rose by $1.7 billion, with credit for automobiles and other consumer goods advancing strongly.

After having risen by 3.8 per cent in the preceding twelve months, the wholesale price index remained unchanged in September and declined by 0.6 per cent in October to 106.2 per cent of its 1957-59 base. Prices for farm products and processed food, taken together, rose somewhat in September but fell markedly in October as supply conditions improved; they nevertheless still remained substantially above year-ago levels. On the other hand, the industrial commodities grouping, which accounts for three quarters of the index, remained unchanged during the last three months. Within the industrial sector, the prices of crude materials declined from July to October, while those for intermediate materials remained roughly unchanged and those for finished goods rose. The prices of hides, skins, and leather dropped sharply during this period, reflecting increased livestock slaughter as well as export restrictions, while the decline of residential construction activity continued to exert its impact on lumber and wood products prices. Nonferrous metal prices also declined, but iron and steel prices, despite some recent weakness, were slightly higher than in July. Price declines were also reported for textiles and rubber products. In contrast, however, capital goods prices continued their steady rise. Wholesale automobile prices, after being lowered in August and September as producers granted rebates to help clear dealers' inventories prior to the introduction of the 1967 models, rose again in October.

The consumer price index, on the other hand, has given no sign of flattening out. It rose by 0.3 per cent in September, despite a 0.2 per cent decline in food prices and even larger reductions in the prices of 1966 model automobiles. The cost of services continued to trend upward, and there were sharp rises in apparel prices.

Despite the improved recent performance of industrial wholesale prices, the general outlook for price developments continues to be a cause for concern. On the cost side, wage pressures appear to be accelerating, and unit labor costs—which have been trending upward since the beginning of the year—are likely to rise more sharply, as the effect of the large settlements reached in the past few months begins to be felt. On the demand side, too, rising personal consumption expenditures, large-scale business outlays on fixed investment, and especially the mounting requirements of the Vietnam war are likely to continue exerting a heavy pressure on productive resources in general. One particularly serious bottleneck is, of course, skilled labor, and the situation did not improve in this respect in September or October. The overall unemployment rate, which had fallen by 0.1 percentage point in September to 3.8 per cent, rose by an equal amount in October, thus returning to the 3.9 per cent level at which it had stood in July and August, and around which it had hovered during the first half of the year. The unemployment rate for married men stood at 1.9 per cent in October. Continued tightness in the labor market was also indicated by the fact that average weekly hours of production workers in manufacturing remained at the very high levels of 41.5 hours in September and 41.3 in October. It is noteworthy that the number of major labor market areas with an unemployment rate in excess of 6 per cent shrank in September to eight; there were ten such areas in August and nineteen at the end of last year.