The Business Situation

At the turn of the year, demand pressures in the economy appear to have eased on balance, but cost increases continue to threaten both the maintenance of orderly economic expansion and the country's balance-of-payments position. Industrial production has advanced only slightly since August. Retail sales have remained on a high plateau since last spring, even though personal income has continued to grow vigorously. At the same time, the expansion of business fixed investment spending—while it has moderated—is continuing and defense expenditures are rising. Moreover, the economy is operating with only a narrow margin of unutilized resources. Unit labor costs are increasing sharply, thus seriously threatening the recent stability of industrial wholesale prices. As for consumer prices, the substantial advances in the prices of services and nonfood commodities show no sign of abating. To be sure, food prices have recently declined at both the wholesale and retail levels, but this is likely to be only a temporary lull.

PRODUCTION, ORDERS, AND INVENTORIES

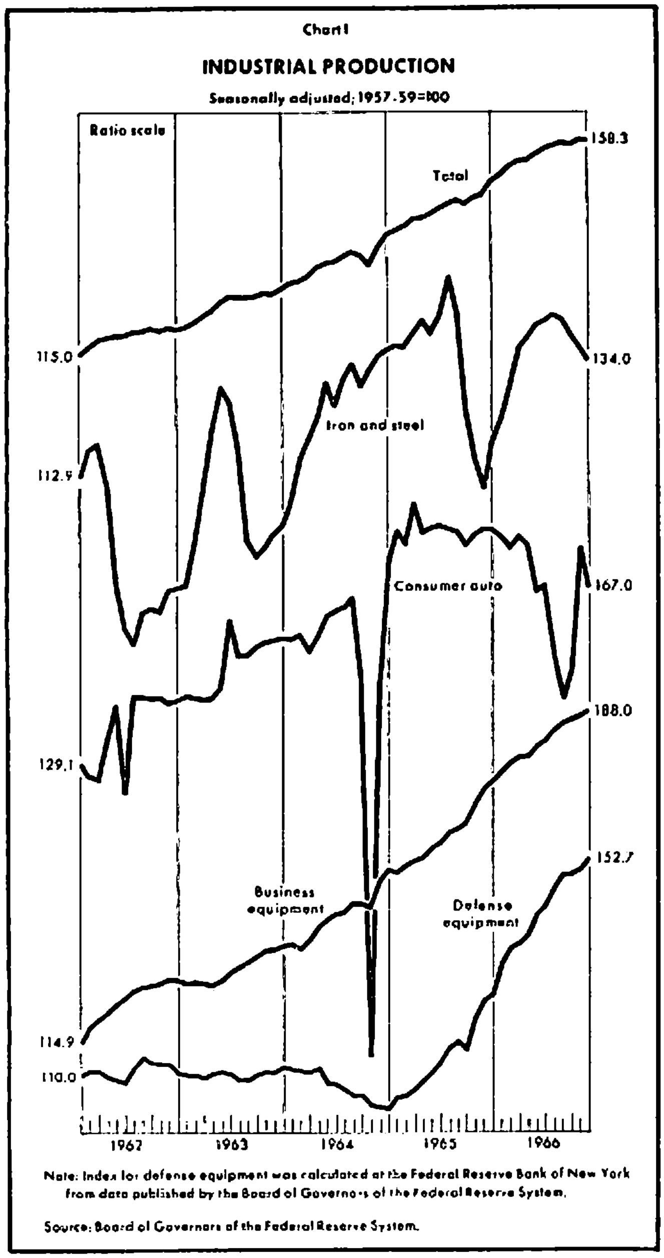
Industrial output eased in November, returning to a level only barely above that of midsummer (see Chart I). The Federal Reserve Board's seasonally adjusted production index, after having increased by 0.5 per cent in October, declined by 0.2 per cent in November to 158.3 (1957-59 = 100). The small November decline was largely the result of substantial cutbacks in automobile assemblies and in iron and steel production. At the same time, however, the output of all other goods, on balance, increased more slowly than earlier in the year.

Automobile production, which had jumped ahead by 20 per cent in October, fell back 6 per cent in November. Assemblies reached a seasonally adjusted annual rate of 8.5 million units during that month, and this rate was maintained in December as well. The recent softening of new domestic auto sales—which contrasts with the continued brisk sales of imported cars—has led producers to lower their sights for the coming months. Although the current levels of auto assemblies are well below those recorded throughout 1965 and early in 1966, they still compare most favorably with prior years. The moderation in the rate of automobile assemblies—along with the housing slump, inventory cutbacks, and stronger competition from abroad—has contributed significantly to the continued decline in iron and steel output. Such output was cut back by 2½ per cent in November, bringing the cumulative decline in iron and steel production from the July peak to almost 7 per cent.

The output of goods other than automobiles and iron and steel, on the other hand, edged up further in November. Defense equipment production, in particular, again rose steeply, while business equipment output also showed a strong advance in November; both rises were, indeed, sharper than in the preceding month (see Chart I). The production of consumer goods other than autos also increased in November, but the output of raw and semifinished materials declined, even after the exclusion of the iron and steel group.

The volume of new orders received by durables manufacturers fell by $1.1 billion in November, to $23.1 billion —the lowest level in a year. As in the preceding month, when new orders had dropped by $1.0 billion, the decline reflected to a large extent a reduction in the volatile series covering defense orders, with a particularly sharp drop in aircraft and parts. The substantially lower volume of new orders resulted in a fractional decline in unfilled orders— the first decline in the orders backlog in three years. The backlogs of transportation equipment and primary metals producers declined, but other manufacturers—notably of machinery—registered a further lengthening of their unfilled orders. The overall backlog, which has risen by $33 billion or 77 per cent since this expansion began, remains of course extremely high and represents the equivalent of 3.3 months of sales at present rates of shipment.

Recent data indicate that inventory accumulation has been proceeding at a high rate. Total manufacturing and trade inventories rose by as much as $1.3 billion (seasonally



adjusted) or 1 per cent in October, as wholesalers' and retailers' inventories rose sharply. The growth of manufacturing inventories, which had been very steep during the summer months—notably in work-in-process stocks at durables manufacturers—on the other hand, moderated in September and October but still remained substantial. In November, however, inventory accumulation rose again to the July-August rate. Work-in-process inventories held by producers of transportation equipment and of machinery increased sharply, and durables manufacturers' stocks of finished goods expanded significantly. The rise in inventories of materials and supplies, in contrast, was moderate. Even though inventory-sales ratios are currently relatively high, further—albeit slower—increases in inventories appear likely. A recent Department of Commerce survey indicates that durables manufacturers foresee further substantial additions to their stocks in the first quarter of 1967.

There are indications that the downtrend in housing construction may be bottoming out even though private residential construction outlays declined further in November. Indeed, residential construction contracts rose sharply in November, by 13 per cent, building permits for new private housing units edged up, and private nonfarm housing starts—a highly erratic series—jumped 20 per cent after having dropped 22 per cent in October. For October and November combined, both permits and starts indicate a relatively small rate of decline—as against the very considerable drop recorded over the spring and summer months—while residential construction contracts increased.

CONSUMER DEMAND, EMPLOYMENT, AND PRICES

Personal income advanced by $3.2 billion in November, to a seasonally adjusted annual rate of $597.6 billion. This increase, the smallest one since July, falls well below the average monthly rise of $4.8 billion recorded in the three months August to October. About one third of the easing from the August-October average increase reflected a lower growth in Government transfer payments; these had, of course, increased very rapidly in the months immediately following the introduction of the Medicare program. Fully half of the slowdown in personal income growth, however, represented a slower expansion in wage and salary disbursements. The November advance in these payments was the smallest monthly increase since April. Nevertheless, the November rise in personal income was substantial, and fully equal to the advances registered in the first half of 1966.

Despite the continuing large rises in consumer incomes, retail sales have changed only little since last spring. In December, sales dropped by about 1 per cent to a $25.4 billion seasonally adjusted level, according to preliminary data subject to major revisions. The December decrease, which followed a smaller increase in November, was apparently the outcome of declines in most sales categories. Paralleling the relative stability of retail sales over the last months, the growth of instalment credit outstanding had slowed substantially, reaching in October a low for the last two years. In November, however, there

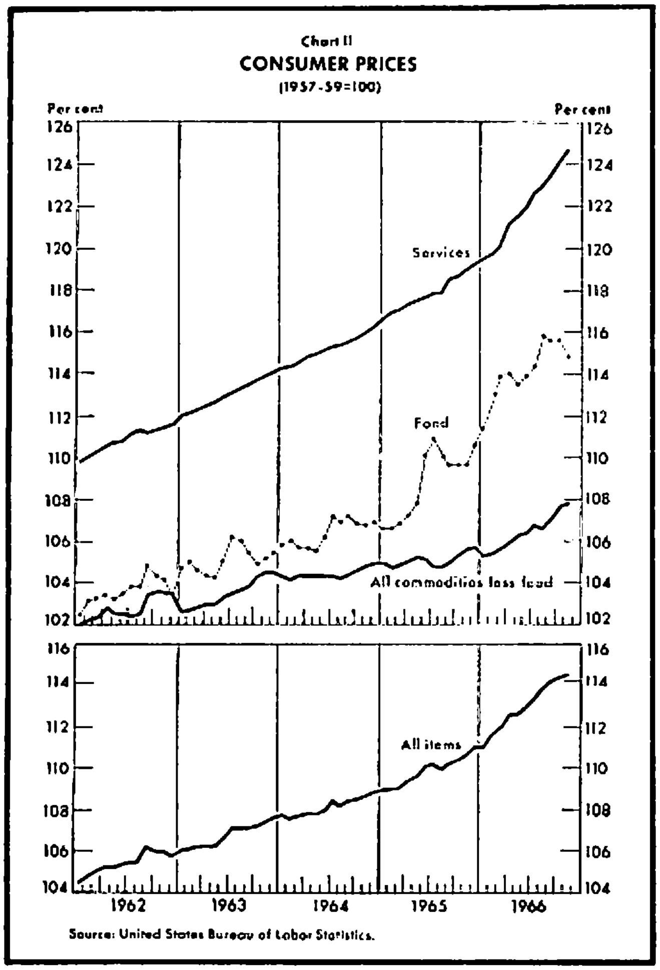


Chart II
CONSUMER PRICES
(1957-59=100)

Source: United States Bureau of Labor Statistics.

was a significant acceleration dominated by an increase in automobile credit.

Even though demand pressures have moderated, the labor market remains tight. The overall unemployment rate, which had dropped by 0.2 percentage point in November, increased by 0.1 percentage point in December to 3.8 per cent. For the entire fourth quarter, the unemployment rate averaged 3.8 per cent—a level equal to that of the first quarter of 1966 and the lowest since 1953. Reflecting continuing manpower shortages, as well as lower productivity gains, labor costs per unit of output in manufacturing have risen sharply month after month since July. At the same time, wage increases in excess of productivity gains have also been characteristic in other sectors of the economy, and notably in service industries.

Wholesale prices declined in November, by 0.3 per cent, after having fallen by 0.6 per cent in October. The declines in both months are entirely ascribable to reductions in the prices of farm products and processed foods. Industrial wholesale prices, in contrast, edged up by 0.1 per cent in both October and November. Further rises in the prices of furniture and other household goods, metal and metal products, and machinery were largely offset by continued declines in the prices of lumber and wood products and of hides, skins, and leather products.

In November, a more than seasonal drop in food prices held the overall increase in consumer prices to 0.1 per cent—the smallest advance since May (see Chart II). However, the bulk of this slowdown reflected seasonal factors. Food prices in grocery stores fell by 0.9 per cent in November, and total food prices, which include restaurant prices, by 0.7 per cent. Outside the food area, however, prices continued to advance briskly. The prices of services, led again by those for medical care, rose at the same rapid pace as in the last few months. The increase in the prices of commodities other than food moderated somewhat; however, apparel prices and housing costs advanced substantially.