The Business Situation

The most recent data on the economy point to a continued moderation in the pace of overall activity. However, the unusually severe weather conditions in many parts of the country from late January through much of March significantly affected production and sales. Consequently, although the February declines in such key measures as industrial production, retail sales, and manufacturers' shipments unquestionably indicate some easing in the economy, these developments nonetheless may provide highly inaccurate indications of the momentum of the economy under normal circumstances. At the same time, a positive factor in the economic outlook is the prospective action by Congress to restore two tax incentives to investment—the 7 per cent tax credit and the use of certain accelerated depreciation allowances—which were suspended last fall. Indications are that the restoration, if approved, might give an appreciable boost to plant and equipment spending this year. Moreover, the availability of accelerated depreciation allowances also has a significant bearing on apartment construction, and the restoration of this tax benefit could thus be expected to result in a further brightening of the prospects for expanded residential building activity.

The considerable moderation of demand pressures during recent months has been reflected in a substantial improvement of the price picture. From October to February the consumer price index rose at an annual rate of only 0.8 per cent, a very modest increase by comparison with the rise at a 3.8 per cent rate during the first ten months of 1966. At the wholesale level as well, price behavior has moderated in recent months. The wholesale index declined by 0.2 percentage point in February, and preliminary estimates indicate that it held steady in March at 106.0 per cent. At that level, the index was nearly a full percentage point below the peak reached late last summer. As in the case of consumer prices, the recent easing of the wholesale index had been preceded by a very sharp rise—at an annual rate of 3.9 per cent during the first eight months of 1966. Declining agricultural commodity prices have been the main factor in the downtrend of the overall wholesale index since the fall; while the industrial component has continued to rise, its advance has been tempered by an easing of prices for nonferrous metals and other raw materials. On the other hand, average labor costs per manhour and per unit of output in manufacturing have continued to move up despite a widespread reduction in the use of high-cost overtime hours.

OUTPUT, EMPLOYMENT, AND CONSUMER DEMAND

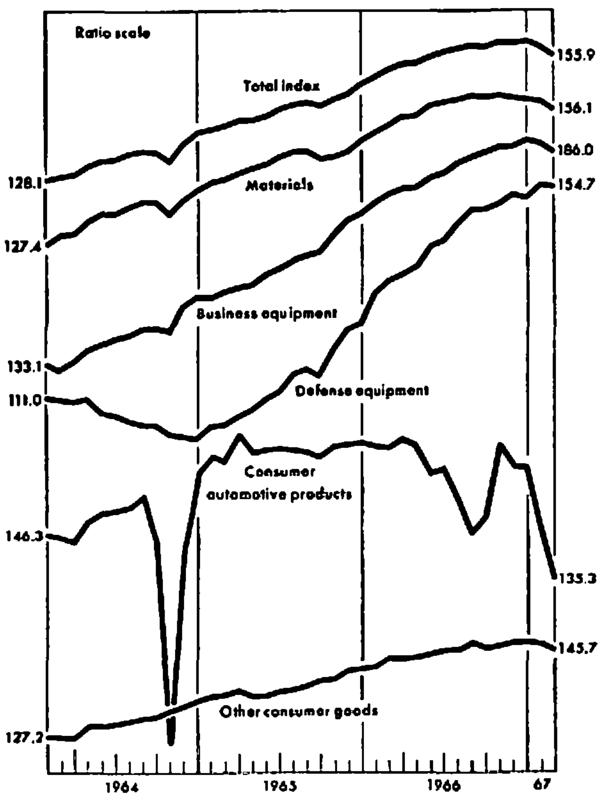
Industrial output dropped off in February for the second consecutive month. The Federal Reserve Board's industrial production index fell by 2.1 percentage points (1.3 per cent) to 155.9 per cent of the 1957-59 average, with declines spread widely through industries producing both materials and final products (see Chart I). The reduction of automobile output was particularly sharp, as the rate of new car assemblies fell by about 15 per cent for the second consecutive month. The steepness of the February decline reflected not only some planned cutbacks by auto producers, in the face of a continuing lack of buoyancy in new car sales, but also the impact of work stoppages and severe snowstorms. The exceptionally sharp February decline dropped the seasonally adjusted annual rate of auto assemblies to a level only slightly above 6 million units, the lowest in some years (apart from the strike period in late 1964). Output recovered substantially in March, however, and producers' schedules point to a further increase in April to a rate of more than 7½ million units.

Unusually severe weather conditions in February played a role in the declines registered in other industrial production categories as well. Output of consumer durables other than autos declined further, while production of nondurable goods for consumer markets showed little change. Activity in the steel industry, in contrast to the trend of recent months, was about unchanged from January to February, though production of most other materials moved lower. Since early last fall, steel production had been declining steadily in response both to a weakening of sales in such important steel-using industries as autos and home appli-

Chart I

INDUSTRIAL PRODUCTION

Seasonally adjusted; 1957-59=100



Note: Indexes for defense equipment and nonautomotive consumer goods were calculated at the Federal Reserve Bank of New York from data published by the Board of Governors of the Federal Reserve System.

Source: Board of Governors of the Federal Reserve System.

ances and to a trend toward greater economizing on inventories by steel users generally. The consensus of industry opinion appears to be that, while there is little likelihood of a significant production upturn over the near term, neither is there a strong prospect of appreciable further declines. In March, however, steel production was apparently reduced once again. Output of equipment, for both the business and defense markets, continued in February to show relatively greater strength than that exhibited by the other major components of industrial production.

The most recent reports regarding orders received by durables manufacturers suggest a continuation over the near term of the current period of sluggishness in the pace of manufacturing activity. The flow of new orders increased slightly in February, following a sharp January decrease, but the volume of unfilled orders on producers' books declined further. Within the durables sector, a substantial recovery of new orders from the reduced January levels was reported by aircraft producers and by the primary and fabricated metals industries, but these gains were largely offset by sharp drops in orders for machinery and motor vehicles. The decline in the latter industry reflected mainly the decline in shipments of motor vehicles, which are treated as essentially equal to new orders. The huge build-up of unfilled orders for durables was, of course, one of the most striking evidences of the excessive pressures on the economy's capacity during 1966. During the course of last year, order backlogs grew by nearly \$14 billion, a rise of about 22 per cent, with virtually all the advance occurring in the first nine months. The moderate decline of backlogs in January and February, totaling about \$1½ billion, reflects the easing in demand conditions that began to develop in the latter months of last year. Since durables producers' shipments have also moved lower in recent months, the unfilled orders on their books at the end of February continued to represent more than 3¼ months of sales at the current rate—a ratio that has shown virtually no change since reaching that relatively high level early last fall.

New construction activity continued to expand modestly in February. Outlays on private residential construction, which had declined through most of 1966 to a very low level in December, rose in February for the second month in a row. Other private construction outlays were about unchanged, while governmental construction spending advanced moderately. The development of easier credit conditions in recent months has contributed to an improvement of prospects for construction activity, all segments of which were affected in some degree by the reduced availability and rising cost of credit during 1966. With respect to the home-building sector, which was of course particularly hard pressed last year, developments in recent months have led observers increasingly to conclude that 1967 will see a substantial recovery in activity as the year progresses. The expected restoration by Congress of the accelerated depreciation allowances suspended last fall should have some favorable effect on apartment house construction. As mortgage interest rates have eased, and funds have become more easily obtainable, both the number of new housing units started and the number of new homes sold have shown an upturn. To be sure, the rate of new housing starts declined in February after three successive advances. To some extent, this reflected unusually poor weather conditions; however, such a swing, coming in the wake of a sharp January rise, is in any event not unusual in so highly erratic a monthly series.

The employment picture in February was somewhat mixed. The unemployment rate in the civilian labor force held at the low 3.7 per cent recorded in December and January. The employment situation of teen-agers weakened a bit but that of adults showed still further improvement. Indeed, the unemployment rate for married men—who are generally considered to be the "backbone" of the labor force—dropped to 1.6 per cent, the lowest figure in the thirteen years during which that rate has been calculated.

The moderation in the pace of manufacturing activity was, however, reflected in the February employment data. Manufacturers slightly reduced the number of production workers on their payrolls, while at the same time the average number of hours put in weekly by these workers dropped quite sharply. Declines in the workweek were widespread throughout the manufacturing sector. Though in part they reflected producers' efforts to adjust to easier demand conditions, unusually severe weather in some areas also played a role. Outside manufacturing, the number of workers on nonagricultural payrolls generally increased, with particularly strong gains in government, the service industries, and construction. In the latter industry, employment has been expanding steadily since last fall and had by February returned to the level prevailing early in 1966.

As a result of the drop in the number of man-hours worked in manufacturing, the aggregate pay of manufacturing workers declined somewhat in February. This put an appreciable damper on the growth of overall personal income. Employee income in other sectors of the private economy continued to expand, however, as did government wages and salaries—particularly at the state and local levels. Nevertheless, even though February income was buoyed by the accelerated payment of veterans' insurance dividends, the month's rise in total personal income was the smallest in nearly a year and only half as large as in January.

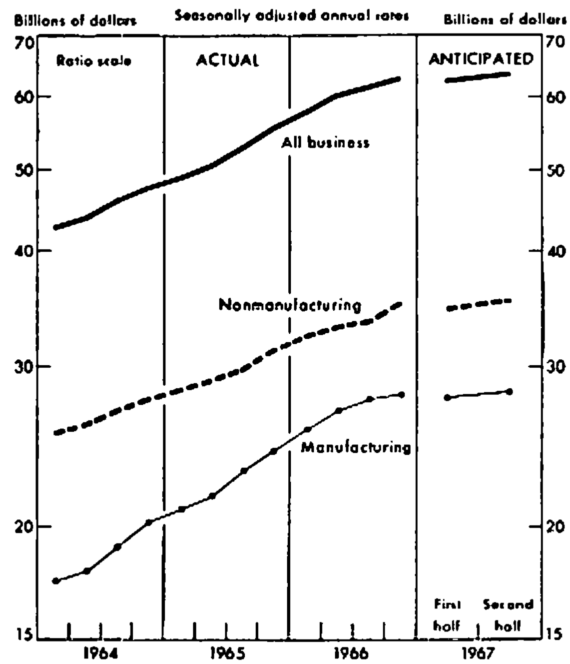
Preliminary figures on retail trade indicate that sales volume declined in February, following a fairly strong rise in January. Taken together, the first two months of 1967 saw no basic departure from the generally sluggish performance that has characterized retail sales for some time. The February decrease was concentrated entirely in durable goods, with sales declines spread generally through the durables sector. The further drop in new car sales in February was one factor in the weakening of dollar sales volume at retail outlets. At a seasonally adjusted annual rate of 7.0 million units, auto sales were off almost 10 per cent from the January pace. Though there was evidence in March of the normal spring pickup in car buying, this trend was dampened by unfavorable weather conditions so that seasonally adjusted sales volume registered only a slight gain over the low February level. Reflecting the sluggishness of retail sales, consumers have been saving an unusually high proportion of their incomes during the past half year. Recent surveys, however, have revealed some improvement in consumer sentiment, which may portend a gradual strengthening of consumer demand.

BUSINESS INVESTMENT

The Commerce Department and Securities and Exchange Commission, in their February survey of capital spending plans, gathered information on anticipated outlays over the full course of 1967. At the time this survey was taken, which was before the President asked Congress to reinstate the investment tax credit and accelerated depreciation allowances, businessmen anticipated that capital spending would expand this year by a modest 4 per cent, or $2.4 billion, reaching a total of $63.0 billion (see Chart II). A rise of this magnitude would be very much milder than those of the past several years, when annual gains in a 15 to 17 per cent range were recorded. Moreover, the February survey indicated a decline in the seasonally ad-

Chart II

ACTUAL AND ANTICIPATED PLANT AND EQUIPMENT SPENDING



Note: Expenditures figures for the first and second halves of 1967 are from the February Commerce-SEC survey.

Sources: United States Department of Commerce; Securities and Exchange Commission.

justed spending rate during the first half of 1967, followed by a renewed advance after midyear. Most major industry groups covered by the survey anticipated greater spending in 1967 than in 1966, though the expected advances were generally more modest than those of recent years.

The findings of the February Commerce-SEC survey were somewhat weaker than those of a special survey taken by McGraw-Hill in the opening weeks of the year that had pointed to a rise in capital spending this year of nearly 6½ per cent. In good measure, the divergence between the two sets of survey findings probably reflects a relative under-representation of small businesses in the sample of firms used by McGraw-Hill. It is generally believed that the suspension of tax incentives to investment, effective last fall and originally intended to run through the end of 1967, had a greater impact on the spending plans of smaller firms. Moreover, the latest Commerce-SEC findings showed a downgrading of planned first-half spending from that reported by the previous Commerce-SEC survey taken last November. To some degree, this downgrading may have reflected a tendency by businessmen to curtail near-term investment plans because of a growing conviction that the suspended tax benefits would be restored at an early date. When the President last fall signed the suspension legislation, he stated that he would promptly recommend an early restoration if circumstances rendered such action appropriate. The chances for an early restoration had appeared to be increasing through the winter, amid growing evidence of an easing in the pressures that had so severely strained the economy's productive resources during most of 1966.

Thus, an important consideration in any assessment of the Commerce-SEC February survey results is the fact that the survey was conducted prior to the President's request for a restoration of the tax benefits. If Congress acts to reinstate the benefits retroactive to March 9, as now contemplated, the outlook for 1967 indicated by the February survey may be subject to substantial upward revision. In December 1966, a special Commerce-SEC survey had found businesses anticipating that, as a result of the temporary suspension of the investment tax benefits, plant and equipment spending in 1967 would be more than $2 billion below the level that would otherwise have been reached. The sharpest downward adjustment was anticipated by the railroads—and indeed the February Commerce-SEC survey found that, among the few industries planning spending cuts in 1967, by far the largest reduction was anticipated by the railroads.

When releasing the results of the special December survey, Government officials cautioned that the figures gave only a very rough indication of the anticipated impact of the tax benefits suspension. Moreover, those figures were based on businessmen's 1967 spending plans as of last December. Nevertheless, the findings of that survey do suggest that early restoration of the tax benefits may provide measurable stimulus to capital spending this year. Further indications in this direction were provided by a poll taken by the National Industrial Conference Board soon after the President's request for restoration of the benefits. The NICB found that close to 20 per cent of the nation's largest manufacturing firms would raise 1967 investment outlays if the tax provisions were reinstated.

Business inventories are currently at a high level relative to sales and, not surprisingly, a Commerce Department survey taken this past February found that manufacturers were then expecting to cut back in the first and second quarters on the size of their inventory increases. Available data indicate that manufacturers have in fact slowed their rate of inventory accumulation. On the basis of preliminary figures, the addition to total manufacturing stocks in February was at less than half the high January pace. Durables producers cut back the rate of accumulation for the third consecutive month, while in nondurables manufacturing there was virtually no net addition to inventories in February following a large January gain. It is generally expected that reduced inventory accumulation in the months ahead will continue to exert a restraining influence on overall economic activity. The extent and duration of the prospective inventory correction are difficult to assess at this time, but the apparent orderly nature of the February downturn in manufacturers' inventory accumulation was an encouraging development.