The Business Situation

As the second half of the year began, the economy continued to show a solid advance. In June, industrial production, nonfarm payroll employment, and personal income all rose, while retail sales were only slightly below the record May level. For the second quarter as a whole, gross national product moved substantially upward and, with prices remaining relatively stable, most of the rise reflected real growth. Fragmentary data for July suggest that after adjustments for seasonal changes—adjustments which are especially difficult at this time of year—auto and steel ingot production and retail sales apparently increased somewhat. In the residential construction area, leading indicators of activity recovered part of their April-May losses in June, but remained below their average levels of winter and early spring.

The business expansion continues to be accompanied by a substantial degree of over-all price stability. The wholesale price index actually tended slightly downward during the first half of this year, reflecting some easing in the prices of farm products and processed foods and essentially no change in the index for industrial goods. At the retail level, the consumer price index has advanced very little in 1964, with the June figure only 0.4 per cent higher than six months earlier as compared with an 0.8 per cent rise during the first six months of 1963.

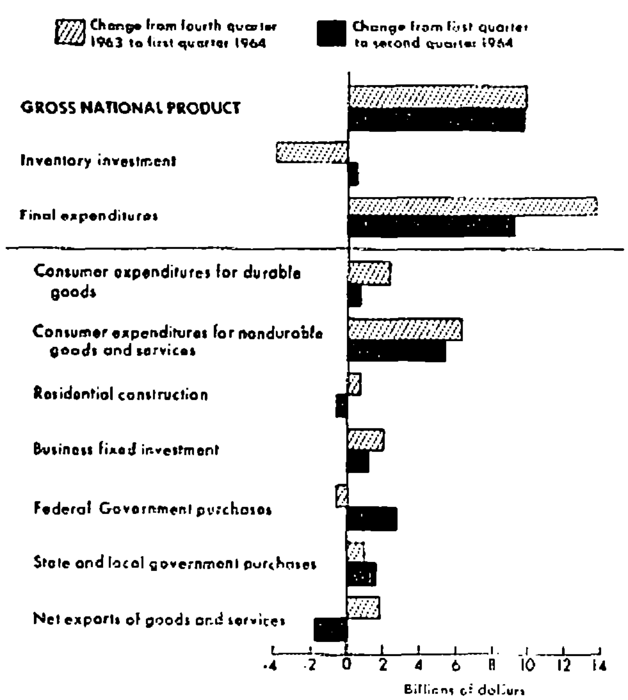
RECENT PATTERNS OF DEMAND

Gross national product rose by $9.7 billion in the second quarter to a seasonally adjusted annual rate of $618.5 billion, according to preliminary estimates of the Department of Commerce (see Chart 1).[1] This gain was about equal to that scored in the previous three months, but moderately smaller than the very large increase recorded in the final quarter of 1963. Virtually all the April-June advance was in final expenditures—that is, in GNP exclusive of the influence of inventory changes. Inventory accumulation rose only modestly, after having dropped

Chart I

RECENT CHANGES IN GROSS NATIONAL PRODUCT AND ITS COMPONENTS

Seasonally adjusted annual rates



Source: United States Department of Commerce.

[1] The usual midyear revisions of the national income accounts resulted in changing the previous estimates of quarterly GNP back through the first quarter of 1961 by as much as plus or minus $2.2 billion, with the figure for 1964-I revised upward by $0.8 billion.

significantly in the first quarter. With stocks remaining conservative in relation to sales, it appears likely that future rises in demand will be readily reflected in higher output.

Consumer spending accounted for about two thirds of the increase in final demand. As noted in a more detailed discussion below, the $6 billion rise in such expenditures during the first full quarter of the tax cut was somewhat less than the huge advance scored in the first three months of the year. However, the latest gain was larger than most of the quarterly increases achieved during the current business expansion. Purchases of nondurables and services were again stepped up strongly, while buying of durable goods rose moderately after a considerable surge in the first quarter. Weekly retail sales data suggest that consumers may have further increased their spending in July, despite the retarding influence on auto sales of a strike by new car haulers in the eastern states.

In the government sector, expenditures at the state and local level during the second quarter continued on their long-term uptrend and Federal purchases also rose significantly. In a somewhat longer perspective, however, it is noteworthy that Federal spending has added much less to aggregate demand in the past year than in the earlier portion of the current business upswing. Continued paring of defense outlays, moreover, is expected to result in lower levels of Federal spending over the rest of the year than were projected in the Budget last January.

Business fixed investment also registered an appreciable rise in the second quarter, continuing the notable strengthening in this sector. Furthermore, the prospect of a sizable advance in capital spending over the balance of the year —indicated in the May survey of businessmen's plans taken by the Commerce Department and the Securities and Exchange Commission—is receiving some confirmation in the strong showing, over recent months, of indicators on contract awards for commercial and industrial construction and new orders for machinery and equipment.

The two components of GNP which fell off in the second quarter are net exports of goods and services and outlays for residential construction. The drop in net exports reflected a substantial increase in imports from an unusually low first-quarter level. As for housing expenditures, the moderate decline was associated with some weakening in April and May in the number of new housing starts and building permits issued as compared with their very high rates during the previous several months. In June, both starts and permits rose by 5 per cent, but remained 6 per cent and 4 per cent below their respective first-quarter averages.

PRODUCTION, ORDERS, AND EMPLOYMENT

The Federal Reserve's seasonally adjusted index of industrial production moved up in June for the tenth successive month, rising by 0.6 percentage point to 131.8 per cent of its 1957-59 average (see Chart II).[2] While the June rise, like the one in May, fell short of the large increase registered in April, it brought the total increase for the first six months of the year to 4 per cent—substantially above the 1 per cent rise in the previous half year, though somewhat less than the large gain achieved in the first half of 1963. The advance in June was rather widespread, encompassing most major market and industrial sectors. Steel and motor vehicle production, however, which contributed significantly to the boost in the index earlier in the year, held about unchanged at very high levels.

In July, steel ingot output—which normally shows a sizable seasonal decline—held about unchanged, reflecting continued strong demand from a broad range of customers. Some trade sources are projecting a record production level of 120 million tons for the year. In the automobile industry—which is currently involved in important labor negotiations—factories were operating at a high rate, as they closed out production of their 1964-model cars in preparation for a longer than usual retooling period to permit substantial styling changes in their 1965 models.

A factor bolstering industrial production has been the steady rise in the backlog of unfilled orders received by manufacturers of durable goods. In June these order backlogs moved up by 1 per cent, to register the sixth consecutive monthly gain (see Chart II). To be sure, the value of new orders received by producers of durable goods remained about unchanged after a moderate decline in the previous month. However, this series would have increased by 2 per cent in June if not for a sharp drop in bookings placed with the defense-oriented aircraft industry, which follow an erratic month-to-month pattern. The over-all level of durables orders, moreover, remained high.

In line with the upward course of economic activity, nonfarm payroll employment (seasonally adjusted) continued to rise moderately in June, increasing by 114,000

[2] The series is in the process of being revised back through January 1961, with the revision largely reflecting the application of newly computed seasonal adjustment factors. Revised totals are available monthly, starting with January 1963; figures for earlier months will be released in the near future. While the data plotted in Chart II are therefore on the revised basis only for January 1963 on, it is not expected that revision of the earlier data will result in any significant change in contour.

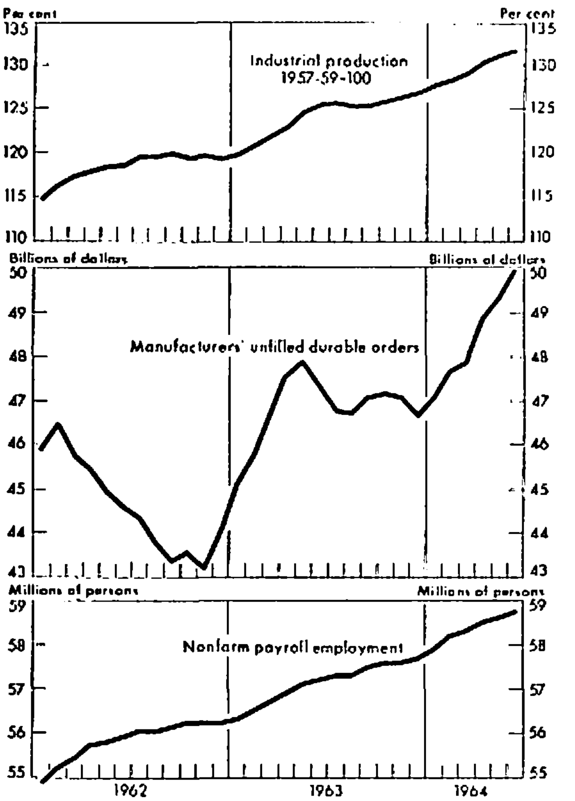


Chart II
RECENT BUSINESS INDICATORS
Seasonally adjusted

Sources: Board of Governors of the Federal Reserve System; United States Departments of Commerce and Labor.

persons, following an advance of only 49,000 the month before (see Chart II). Most of the June increase occurred in service industries and in state and local government employment. Since the end of last year, the number of nonagricultural jobs has increased by a little over 900,000 —appreciably more than in the previous six months, though slightly less than in the first half of 1963.

RECENT CONSUMER BEHAVIOR

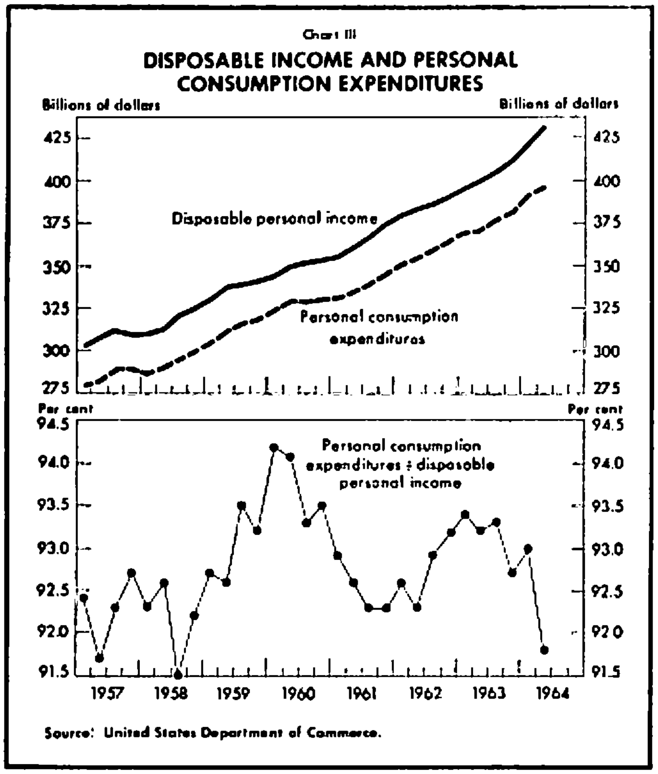
As noted earlier, the American consumer continued to provide a major stimulus to the sustained expansion of the economy in the second quarter. Consumption spending directly absorbs the bulk of the economy's output and indirectly supports business investment in inventories and plant and equipment. While consumption is subject to a wide variety of influences, its most important single determinant in normal times is the level of income available to consumers after taxes—so-called disposable income. One of the main aims of the recently enacted tax legislation was the stimulation of economic activity by increasing disposable income in the hands of consumers; observers of the business scene in recent months have, therefore, been trying to assess the impact of the tax cut on spending.

Certainly there can be little question that the tax cut has given a psychological boost to the economy. And it is reasonably clear that the concrete support given to consumer incomes will—at least after a time—result in higher consumer spending than would otherwise take place. Nevertheless, with data available for only a few months, any attempt to measure the immediate impact of the tax cut on consumer spending is bound to be somewhat frustrating. The relevant economic time series are subject to short-term fluctuations, some of them erratic, and these fluctuations can be large enough to obscure underlying trends. Moreover, no statistical data are completely free of error, and data that must generally be used in analyzing the most recent developments are frequently only preliminary estimates.

The initial estimates for the April-June quarter, the first quarter in which the tax cut was fully in effect, show a sharp \$12 billion increase—see Chart III—in disposable income (seasonally adjusted annual rate), the largest quarterly increase on record. Since before-tax personal income rose by only \$7 billion, roughly \$5 billion of the increase in disposable income between the first and second quarters is attributable to a decline in tax receipts.[3]

The sizable \$6 billion increase in consumption spending in the second quarter was all the more impressive coming after a near-record rise of almost \$9 billion in the first quarter. The second-quarter gain, however, amounted to only about 50 per cent of the increase in disposable income. To be sure, if the ratio of additional spending to additional disposable income is measured over the first half of 1964 as a whole, the result is a markedly higher 73 per cent. Yet even this figure is substantially below

[3] Actually, the \$5 billion figure probably understates to some extent the difference between actual disposable income in the second quarter and what disposable income would have been had there been no tax cut. First, part of the effect of the tax cut was already felt in the first quarter, since the cut became effective on March 5. Second, in the absence of the tax cut, total income tax collections (which include state and local tax collections as well as Federal personal income taxes) would actually have shown some increase. If this increase is deducted, the estimate of the total effect of the Federal income tax cut on disposable income would be somewhat higher than \$5 billion. Finally, it is possible that before-tax incomes would not have been so large in the absence of the generally stimulating effects of the tax cut on the economy as a whole.



the usual proportion of disposable income that has been spent on consumption in recent years.

After a burst of spending following the end of World War II, the consumer has consistently tended to spend in the neighborhood of 93 per cent of his after-tax income on goods and services. In individual quarterly periods during the last ten years, this ratio has been as low as 91.5 per cent and in the first quarter of 1955 as high as 94.5 per cent. In the current economic expansion, the ratio—until the second quarter of this year—moved within a narrower range of 92.3 per cent to 93.4 per cent (see Chart III). Small as this 1.1 percentage point range of variation may appear to be, it amounts to nearly $5 billion of spending at current income levels, a not inconsiderable amount relative to the size of other potential influences on the magnitude of changes in GNP.

The consumption ratio fell in the second quarter to 91.8 per cent, about 0.5 percentage point under the low end of the recent range and the lowest value recorded for this ratio since the third quarter of 1958. In dollar terms, if the consumption ratio in the second quarter had fallen merely to the low end of the recent range, instead of to the still lower value actually recorded, $2 billion (on an annual rate basis) would have been directly added to the $6 billion increase that actually took place.

Since personal saving as measured in the national income accounts is simply the difference between disposable income and estimated consumer spending on goods and services, the apparent fall in the consumption ratio during the second quarter had as its counterpart a rise in the ratio of current saving to income. In other words, it thus appears that a relatively large proportion of the initial effect of the tax cut has been on saving. A rise in saving may take the form of a stepped-up rate of acquisitions by consumers of financial assets or repayments of outstanding indebtedness, or both. Data from the national income accounts showing a rise in the saving ratio in the April-June period are thus consistent with evidence of some increase in the rate of consumer debt repayments. (Credit extensions to consumers also rose somewhat, but growth in credit outstanding was below the first-quarter rate.) In addition, a substantial rise in the volume of new securities issues during the quarter—highlighted by the $1.2 billion American Telephone and Telegraph issue of common stock—may have absorbed some of the increased saving.

It must be remembered, however, that even a substantial rise in current saving, when spread out over the many forms which it can take, is unlikely to cause dramatic movements in specific financial series. Moreover, increases in holdings of particular financial assets may reflect shifts in the forms in which existing wealth is held as well as net additions to wealth through current saving. For these reasons, attempts to associate changes in holdings of any specific type of financial asset with a rise in saving stemming from the tax cut should be viewed with some degree of skepticism.

The tendency for the ratio of current saving to disposable income to rise when disposable income shows the sort of very rapid advance experienced in the second quarter has historical precedents. Indeed, the hypothesis that consumers respond to changes in their income with some lag has been supported by a number of econometric studies.[4] For a variety of reasons, many consumer purchases, particularly in the service component, can be expected to respond only very slowly to increased income. Thus, outlays on rent and interest charges on debt reflect decisions made in the past, while medical and legal expenses are not closely related to income. Moreover, a

[4] See, for example, Albert Ando and E. Carey Brown, "Lags in Fiscal Policy", in the Commission on Money and Credit's volume of papers, *Stabilization Policies*, 1963, pages 97-163.

significant portion of spending on nondurable commodities, particularly food, probably reflects long-established habits, and thus such expenditures too are not likely to show sharp variations as income moves ahead. Nevertheless, the increases in disposable income stemming from the tax cut can certainly be expected to exert long-run support to consumer spending, and some recovery in the consumption ratio would seem to be a reasonable expectation. Consumer buying plans remain strong, and record levels of expenditures on durables, the most volatile component of the consumer budget, indicate a continued willingness to spend.