The Business Situation

The firm upward course of economic activity has continued. Despite a drop in the pace of inventory accumulation, gross national product registered another substantial rise in the third quarter. Most of this gain reflected a strong rebound in the rate of increase in consumption expenditures following a lag immediately after the March tax cut. Among the monthly indicators, appreciable increases were scored in September in personal income, nonfarm payroll employment, and in the backlog of unfilled orders for durable goods. To be sure, the industrial production index barely edged forward in September, but this modest showing was largely attributable to the General Motors strike, which started on September 25. That strike, lasting four weeks or more at the various company installations, dampened business activity again in October, as sharp declines in the automotive sector inhibited over-all production and retail sales. With all the General Motors labor disputes now settled—and the very recent strikes at a number of Ford plants expected to be of short duration—activity should intensify to meet the pent-up and continuing demands for automobiles.

As the economy continues to move ahead, attention is being increasingly focused on the possibility that upward pressures on prices may become more intense. The broad price indicators have continued to reflect a substantial degree of over-all stability. Thus, the consumer price index has increased somewhat less so far this year than in the comparable period of 1963, and weekly October data suggest that the industrial component of the wholesale index was only faintly above its year-earlier level, in part reflecting a slight rise since mid-September. Yet, announcements of specific price increases have become more numerous of late, affecting such important products as sulphuric acid, zinc, lead, reinforcing steel bars, and steel pipes. With very high operating rates in a number of industries, reports of shortages of several types of skilled labor, and the possible spread of labor cost pressures spurred by the substantial gains obtained by the auto workers, price stability may now be approaching a period of testing.

RECENT DEVELOPMENTS IN KEY DEMAND SECTORS

Gross national product rose by $8.9 billion in the third quarter to a seasonally adjusted annual rate of $627.5 billion, according to preliminary estimates of the Department of Commerce (see Chart I). The increase was slightly less than the gain achieved in each of the first two quarters of the year, but a bit higher than the average quarterly advance since the end of 1962. Indeed, excluding inventory changes, the third-quarter advance in expenditures was the second largest quarterly increase since 1961. Furthermore, the $2 billion decline in the rate of inventory accumulation—on top of an already conservative ratio of stocks to sales at midyear—makes it even more likely that a continued rise in demand in the current period will be accompanied by increased output.

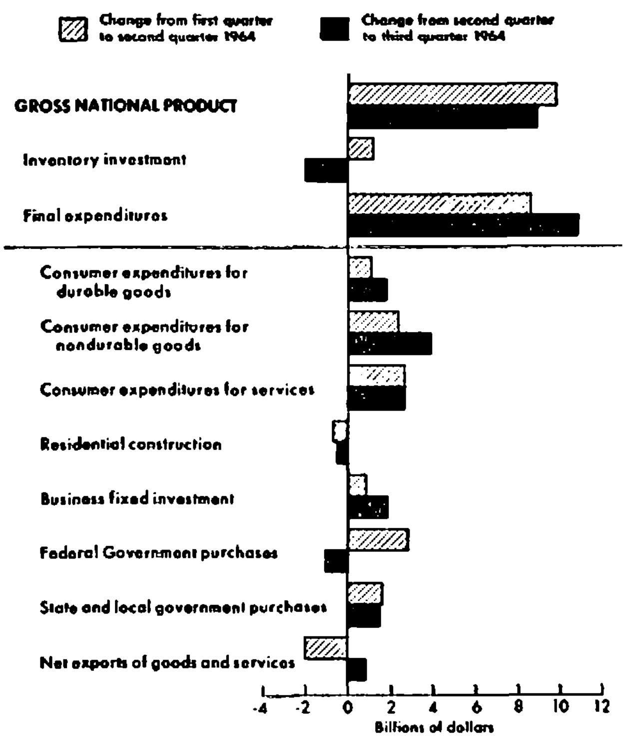
The most important factor in the rise in over-all spending in the third quarter was the $8.4 billion expansion in consumer outlays. The consumption increases were widespread among durables, nondurables, and services. At the start of the fourth quarter, however, spending on durables was retarded when strike-induced shortages caused October new-car sales to decline by 30 per cent. With cars now rolling off the assembly lines at an improved rate, trade sources expect the automotive sector to contribute significantly to retail volume in the final two months of 1964.

Business fixed investment has continued to be a major source of strength in the economy, rising at a seasonally adjusted annual rate of $1.8 billion in the third quarter. A further substantial increase in plant and equipment expenditures is expected in the current quarter, according to the August Commerce Department-Securities and Exchange Commission survey of businessmen's plans (made public some two months ago). Two surveys bearing on capital spending next year have recently been released. According to one, taken in July by the National Industrial Conference Board, major manufacturing corporations estimated that their third-quarter appropriations for plant and equipment

Chart I

RECENT CHANGES IN GROSS NATIONAL PRODUCT AND ITS COMPONENTS

Seasonally adjusted annual rates



Source: United States Department of Commerce.

would be 14 per cent higher, after seasonal adjustment, than the record rate achieved in the previous three months. In the past, appropriations have tended to be reflected in actual expenditures some two to three quarters later. The second recent survey, taken by McGraw-Hill in October and early November, indicated that businessmen plan to raise their plant and equipment spending next year by 5 per cent over the level for 1964 as a whole. A year ago this survey pointed to a 4 per cent rise from 1963 to 1964, far less than the 13 per cent increase that is now expected to be realized. Indeed, all the previous McGraw-Hill fall surveys which preceded a full year of business expansion underestimated the extent of the rise in capital spending that actually occurred. On the other hand, the survey has tended to be on the high side for those years when the economy turned down.

Residential construction has weakened somewhat of late. Private housing outlays declined by $0.5 billion in the third quarter, following a $0.7 billion drop in the preceding quarter (both at seasonally adjusted annual rates). The latest forward-looking indicators of housing activity, moreover, do not suggest any near-term strengthening in this area. Thus, in September nonfarm housing starts were only moderately above August's nineteen-month low, and the number of building permits issued dropped to its lowest rate since February 1963. Over the longer term, of course, the continued rise in family formation makes it likely that residential construction will show renewed vigor.

In the government sector, spending at the state and local levels continued on its long-term uptrend in the third quarter. This increase was almost offset, however, by a sizable decline in Federal purchases of goods and services. Over the past year as a whole, the rate of increase in Federal expenditures has been substantially less than in the previous several years, and current estimates suggest that this sector will provide little further push to economic activity over the next few quarters.

PRODUCTION AND EMPLOYMENT

The Federal Reserve's seasonally adjusted index of industrial production inched up by 0.2 percentage point in September to a record 133.9 per cent of its 1957-59 average. This was the smallest monthly advance since last November, but the smallness of the advance of course reflected the special impact of a 12 per cent drop in automobile assemblies associated with the General Motors strike. Had that large concern been able to meet its original production schedules, the over-all index would have registered about the same sizable gain as in August. Iron and steel production edged up again, to its highest rate since the period of inventory accumulation just after the long strike in 1959, and output of most nondurable goods also increased. Moreover, business equipment output remained at an all-time high despite the reduced production of General Motors trucks. Partial data for October indicate a further 44 per cent cut in automobile assemblies but an additional rise in steel ingot production. The strength in steel output may well in part have reflected some hedging against the possibilities of a price boost and a strike which, under the terms of the steel labor agreement, could take place after April 30, 1965.

The number of persons on nonfarm payrolls increased by a moderate 103,000 in September (after seasonal adjustment). A rise in manufacturing employment and the increased hiring of teachers to instruct the expanding school population more than offset the drop in construction jobs. Compared with a year earlier, nonfarm payroll employment was up by 1.6 million persons, a somewhat greater gain than in the previous twelve-month period. In

October, total employment (as measured by the Government's household survey) was unchanged, and the unemployment rate remained at 5.2 per cent. Over the past four months the rate has averaged 5.1 per cent, or 0.5 percentage point less than in the comparable period of 1963.

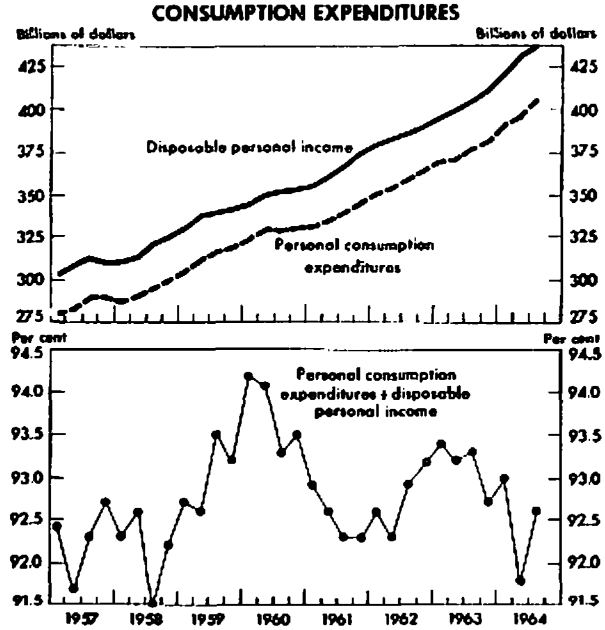
RECENT CONSUMER BEHAVIOR

The large third-quarter increase in personal consumption outlays noted earlier suggests that the additional income provided by this year's tax cut is now being used more freely for consumption purposes. One of the aims of the new tax law was the stimulation of consumer buying through an increase in the amount of disposable income in the hands of the public. The results for the April-June quarter—the first full quarter in which the tax cut was in effect—suggested that its immediate impact on spending had been relatively limited. During that period, disposable personal income increased at a seasonally adjusted annual rate of some $12 billion—roughly $5 billion of which was directly attributable to a decline in tax payments—while consumer spending rose by $6 billion. Thus, only about half of the additional income was used to purchase goods and services, and the ratio of consumption expenditures to disposable income dropped to 91.8 per cent, the lowest level for any quarter since 1958 and significantly less than at any other time during the current business expansion (see Chart II). In the third quarter of 1964, however, consumer spending rose by $3 billion more than disposable income, and the consumption ratio increased to 92.6 per cent, very close to the 92.8 per cent average of the past ten years.

The behavior of consumption in relation to disposable income over the past two quarters should not have been totally unexpected. As indicated in the August 1964 issue of this *Review*, empirical studies suggest the existence of a historical tendency for the consumption ratio to decline over the short run when disposable income is advancing very rapidly. It is still too early to attempt a definitive evaluation of the effects of the tax cut on consumer spending. Nevertheless, the third-quarter experience is at least consistent with the view that increases in disposable income stemming from tax reductions are having much the same impact on consumer spending as do increases in after-tax income stemming solely from an expansion of economic activity.

Chart II

DISPOSABLE INCOME AND PERSONAL CONSUMPTION EXPENDITURES



Source: United States Department of Commerce.