The Business Situation

Domestic economic activity has continued to post substantial gains so far this fall. To be sure, the overhang of steel inventories had an adverse effect on the industrial production index in September and probably also in October. Nevertheless, the underlying forces of business expansion remain dominant. The economy advanced vigorously in the third quarter, as gross national product rose to a seasonally adjusted annual rate of $677 billion. Consumer sentiment is buoyant, and business investment plans point to continued gains in capital outlays over the coming months. Government spending is also expected to advance further, to a considerable extent because of stepped-up military operations in Vietnam.

Economic expansion is currently taking place against a background of a fairly small margin of unutilized capacity and labor resources. No serious bottlenecks seem to have developed over recent months, but with unemployment down to the lowest levels in eight years, employers have generally experienced some difficulty in recruiting skilled personnel. The further growth expected in the labor force over coming months, and the additions to capacity that will stem from the currently high level of capital spending, will work to preserve balance between over-all supply and demand forces in the market. This balance, however, is a delicate one and requires that businessmen, labor, and fiscal and monetary authorities make a constant effort to maintain the orderly pace of the expansion in a noninflationary environment.

Consumer prices resumed their upward trend in September, bringing the rise in the consumer price index to 1.7 per cent for the past twelve months. In contrast to increases earlier this year, which had resulted largely from higher food prices, the latest advances were primarily among nonfood items. Increases in the prices of services were exceptionally large. Seasonally adjusted industrial wholesale prices also rose in September, but appear to have edged down in October.

PRODUCTION, ORDERS, AND EMPLOYMENT

The Federal Reserve Board's seasonally adjusted index of industrial production declined as expected in September—by 1.5 percentage points to 142.8 per cent of the 1957-59 average. This decrease, the first since last October when strikes in the automobile industry cut into industrial production, resulted largely from a sharp reduction in steel output after the signing of the steel labor contract on September 6. The iron and steel component of the index declined by nearly 13 per cent in September, accounting for over two thirds of the drop in the total index. Production was also curtailed by strikes in the aircraft, automobile, newspaper, and coal industries, while hurricane effects caused a drop in crude oil output in the Southern states. On the other hand, output of business and defense equipment continued to rise in September, reflecting the persistent uptrend in business capital spending and the military buildup.

Despite the September decline in over-all industrial production, for the third quarter as a whole manufacturing industries continued to operate on average at around 90 per cent of estimated capacity. This level of operation, maintained since the start of 1965, is the highest since the first quarter of 1956 and is in the range usually associated with optimum efficiency. It was first reached in the opening quarter of the year, when demand for steel began to surge and when the automobile industry worked a substantial amount of overtime in order to make up for output lost during the late-1964 strike. Capacity itself has steadily grown under the impetus of businessmen's capital spending programs. Since output has also rapidly grown over the year, however, utilization rates have remained high. Indeed, according to a recent McGraw-Hill survey, operating ratios are equal to, or greater than, the "preferred" rates in the automobile and parts, rubber, textile, nonferrous metals, machinery, pulp and paper, food and beverages, and petroleum and coal industries.

During October, steel output continued to fall off because of the overhang of inventories built up earlier in the year, and newspaper and aircraft strikes persisted for at least part of the month. At the same time, some of the industries that helped to pull down total production in September—notably automobiles and coal—appeared to do better in October. In fact, weekly figures indicate that automobile workers assembled new cars at an annual rate

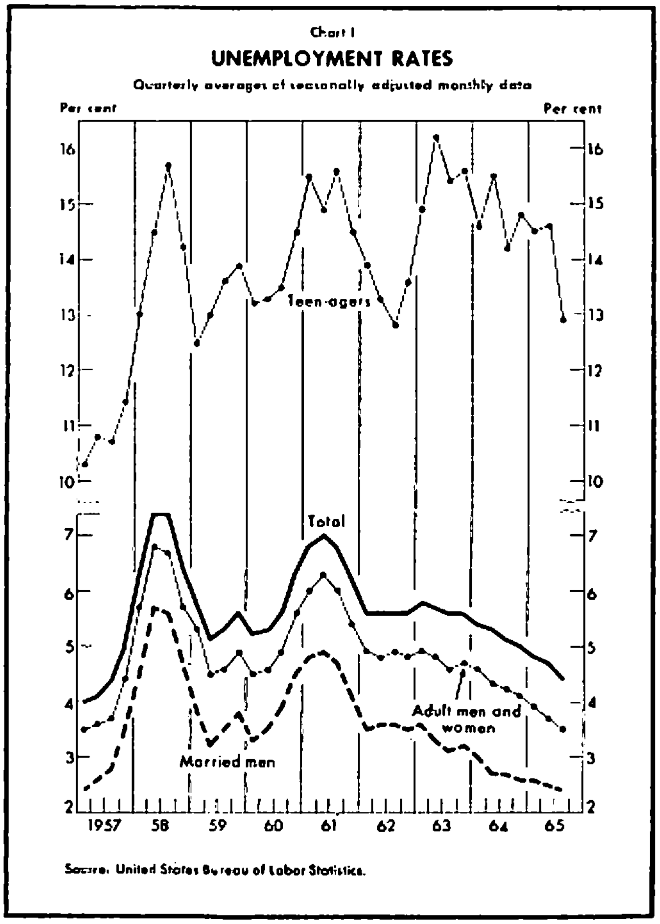

Chart I
UNEMPLOYMENT RATES
Quarterly averages of seasonally adjusted monthly data

Source: United States Bureau of Labor Statistics.

of 9.2 million units (seasonally adjusted). Moreover, except for the steel industry, the flow of new orders coming into durables manufacturers bodes well for production over the months ahead. Thus, bookings received by industries other than steel rose by about 3.0 per cent in September, and the over-all backlog of unfilled durables orders moved up for the twenty-first consecutive month. At current rates of output it would require nearly three months of production to fill these orders.

Despite the decline in industrial production in September, manufacturing as well as total nonagricultural payroll employment rose further during the month. Even in the steel industry, the adjustment to lower production levels was accomplished largely by cutting average weekly hours rather than by laying off workers. Reflecting the strength in employment, the total number of persons listed as unemployed in October fell to 3.3 million. The over-all unemployment rate for the month dropped to 4.3 per cent of the civilian labor force and the rate for married men declined to 2.1 per cent. It is both noteworthy and gratifying that these unemployment rates are the lowest in eight years (see Chart I). Moreover, the rate of unemployment has fallen more rapidly in the last twelve months than in any comparable period of the current expansion except in its earliest stages.

PATTERNS OF DEMAND

The nation's total output of goods and services (measured at a seasonally adjusted annual rate) rose by $11.0 billion in the third quarter, according to preliminary estimates of the Commerce Department (see Chart II). This was a slightly greater gain than in the preceding three-month period, and was also larger than the average quarterly advance during the preceding year. The rate of inventory accumulation fell off again in the third quarter, though considerably less than in the preceding three months. The incentives for building up steel stockpiles

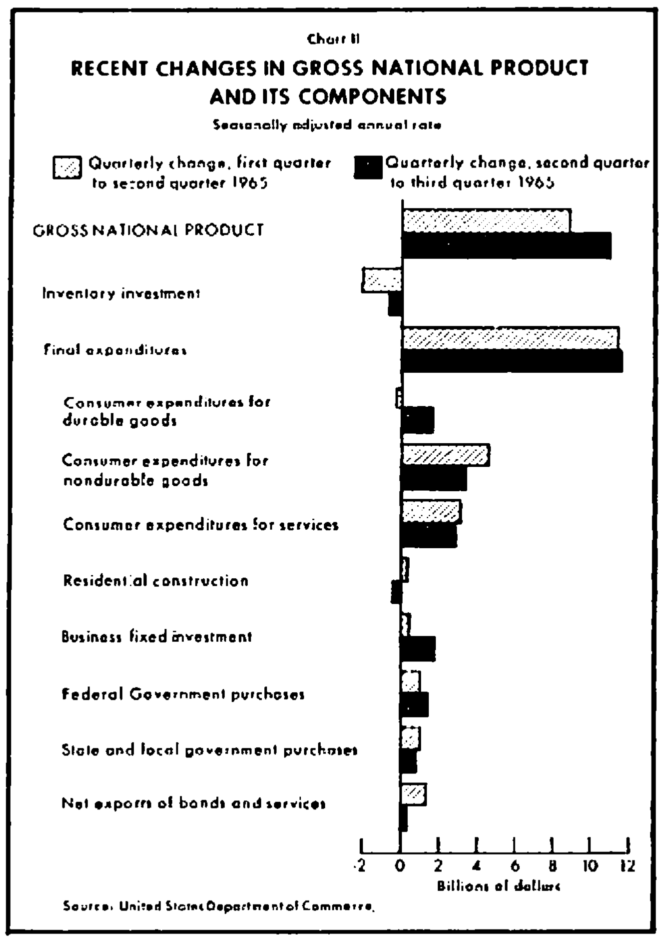

Chart II
RECENT CHANGES IN GROSS NATIONAL PRODUCT AND ITS COMPONENTS
Seasonally adjusted annual rate

Source: United States Department of Commerce.

were reduced as the threat of a steel strike faded and finally ended. The gain in final expenditures (total GNP other than change in inventories) in the third quarter was equal to the solid advance in the preceding three months, and substantially above the average increase of the previous four quarters.

Consumer spending rose in the third quarter by about the same amount as in the preceding quarter. There was a large gain in purchases of durable goods, accompanied by slightly smaller advances in spending for services and nondurable goods. Among the durables items, it was encouraging that there seemed to be continued interest in furniture and other big-ticket household items along with the sustained strength in sales of new automobiles. The rise in consumption outlays was accompanied by an increase in the rate of personal savings. It must be remembered that the increased savings reflect at least in part the September surge in incomes resulting from a lump-sum payment of higher social security benefits. Spending out of this income bulge will be one of the factors affecting both total consumption and the savings ratio during the fourth quarter.

Business investment in plant and equipment continued to advance in the third quarter. As noted, operations in many manufacturing industries have continued to run close to reasonably full rates of capacity utilization, helping to explain why businessmen have raised capital spending plans throughout the year. Moreover, according to a recent McGraw-Hill survey, plans for 1966 already point to capital outlays of $55 billion, or 8 per cent higher than the amount expected for this year. This gain, 3 percentage points above the first estimate for 1965, is McGraw-Hill's largest initial estimate for any year of the current expansion. Planned advances are spread among almost all major industries.

Among other demand sectors, outlays for residential construction, which had risen only slightly in the April-June period, slipped again in the third quarter. The decline in the number of housing starts from June through September reduces the possibility of a sustained upturn in housing outlays in the immediate future. The recent lack of advance in housing construction, however, falls into better perspective if it is recalled that third-quarter outlays were below only five other quarters of the current expansion of more than 4½ years' duration.

In the government sector, the combined total of Federal, state, and local outlays on goods and services was up by $2.2 billion during July-September, with the entire $1.4 billion advance in the Federal sector accounted for by increased defense spending. The military commitment in Vietnam points to still further increases in defense outlays in the months ahead. Decisions on the military budget reportedly will have a major influence on other Federal expenditure plans as well. Since defense needs necessarily rate the highest priority, any curbing of total expenditures will have to involve a full examination of other Federal expenditure plans.