

The Business Situation

As the current business expansion rounds out its fifth full year, domestic economic activity continues to move ahead with undiminished vigor; and indeed there has been some acceleration in the pace of the advance in recent months. Despite a reduction of excess steel inventories, the fourth-quarter gain in gross national product (GNP) exceeded that recorded in the third quarter, and the expansion in both employment and industrial production speeded up. All current indications point to further strong advances in economic activity in 1966. The push that is expected from further gains in consumption and in business capital spending will be strongly reinforced by Government spending for goods and services as projected in the Administration's budget. Expanding military requirements, which are the major factor in the projected rise in Federal purchases, are already having a discernible impact on the economy. The difficulty of forecasting precisely the future trend of such requirements constitutes a source of uncertainty in any current assessment of the balance between likely demand conditions and resource availability during the months ahead. Although present estimates point to only a small deficit in the administrative budget in fiscal year 1967—and to a small surplus in the more comprehensive cash budget—these finely balanced calculations could be upset by developments at home or abroad.

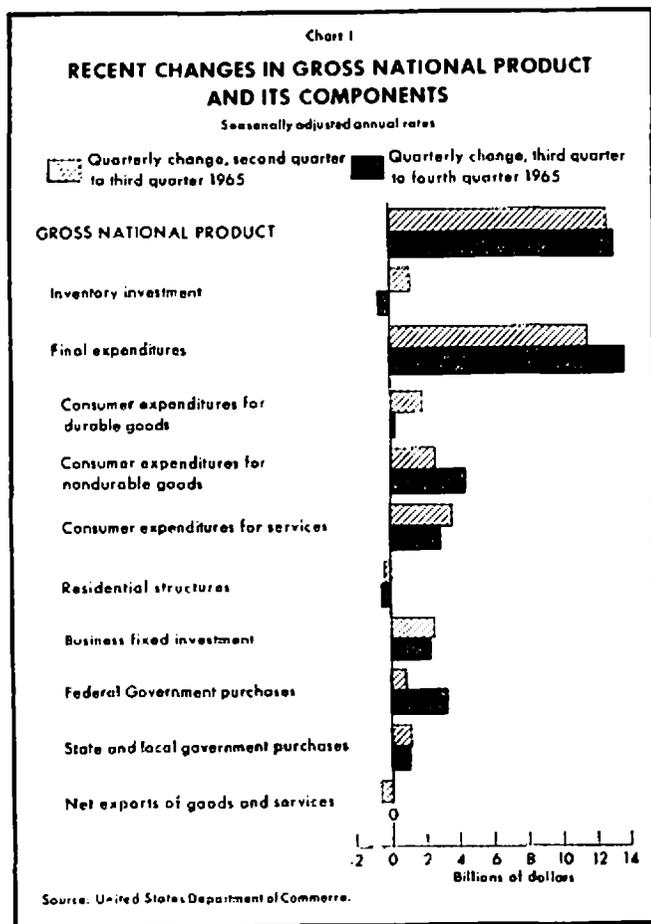
Recognizing the potential risk of excessive demand pressures, the President has asked Congress to repeal temporarily the automobile and telephone excise tax cuts that became effective on January 1, to bring personal withholding tax payments more in line with actual tax liabilities, and to accelerate the shift of corporate tax payments to a pay-as-you-go basis. While the two latter measures would leave actual tax rates unchanged, they would increase tax collections this year and thus might result in some postponement of business and consumer spending, although the magnitude of such an effect is extremely hard to predict. Even after allowing for the possible effects of the measures proposed by the President, the Council of Economic Ad-

visers has projected that the increase in GNP for 1966 as a whole will nearly match, and may possibly exceed, the \$47 billion gain recorded last year. The Council's projection puts GNP this year in the \$717-727 billion range with a midpoint of \$722 billion which, if realized, would represent a rise of nearly 7 per cent.

The high rate of growth in aggregate demand now in prospect strongly suggests that this year will witness a further reduction in the margin of unutilized resources and continued upward pressure on prices and costs. Meanwhile, prices continue to rise. The wholesale price index advanced sharply in December, and some further increase apparently occurred in January. Although the rise in the over-all index in recent months was largely attributable to continuing increases in agricultural prices, the prices of a number of industrial products have also risen. Supply shortages are causing persistent upward pressure on some prices, and the daily price index for a group of important raw industrial commodities has advanced steadily for several months. In January, this index reached its highest level in more than a decade. Prices moved markedly higher in December at the consumer level as well, in large part because of a renewed advance in food costs. Prices of other consumer goods and of services also continued to rise, however.

RECENT PATTERNS OF DEMAND

Aggregate spending for goods and services increased by \$13.1 billion (seasonally adjusted annual rate) in the fourth quarter of 1965, according to the Commerce Department's preliminary estimate (see Chart I). This increase was somewhat larger than that recorded in the preceding three months, and was in fact one of the largest quarterly gains of the entire current business expansion—exceeded only by a slightly larger gain very early in the upswing and by the rise of \$16.5 billion in the first quarter of 1965 when economic activity rebounded sharply



from the effects of the auto strikes late in 1964.

Federal Government spending for goods and services provided an important boost to the expansion of aggregate demand in the fourth quarter of 1965. In contrast with the very mild uptrend of recent years, Federal outlays advanced sharply to register their largest quarterly gain in more than a decade. While the unusually large size of the advance was partly attributable to the fact that a Federal pay increase took effect during the quarter, a significant share of the gain reflected the current program of expansion in the armed forces and in military procurement. State and local government spending once again provided a modest contribution to demand expansion in the October-December period.

The pace of business inventory accumulation appears to have moderated slightly in the fourth quarter, with investment in additions to stocks running at an annual rate \$0.6 billion below that of the preceding three months.

There was a sharp decline in steel inventories in the fourth quarter, following the strike-hedge buildup earlier in 1965, and this special influence was responsible for the slowdown in over-all inventory accumulation. There continued to be a sizable expansion in nonsteel inventory holdings. In contrast with inventory investment, the volume of business fixed investment increased once again in the fourth quarter. The vigorous growth of capital spending was a very important factor contributing to the expansion of over-all GNP throughout 1965, and present indications point to yet another large gain this year.

Residential construction spending, the one major demand component that has failed in the past two years to share in the over-all expansion of economic activity, slowed once again in the fourth quarter. Some developments in the final months of 1965, however, suggested that a limited improvement may be seen at least over the near term. Private nonfarm housing starts moved up sharply in November and December, with the rate in the latter month reaching the highest level in nearly two years. Also, the number of units authorized by newly issued building permits increased in December for the third consecutive month, and likewise reached the highest level in nearly two years.

Buoyed by the steady rise in employment and incomes and by a sustained high degree of confidence, consumer demand for goods and services continues to provide an important thrust to the over-all expansion of output. There was a slowdown in the pace of spending on automobiles in the fourth quarter, following an exceptionally strong third quarter, and the growth of total outlays for durable goods was thus held to a moderate pace. However, demand for nondurables surged ahead—although the size of the gain partly reflected the trend to higher prices for food and apparel—and spending on services continued to expand at a rate in line with the average during the past two years.

The new car sales picture has been somewhat distorted recently by the impact of actual and proposed changes in the automobile excise tax. In January, when the excise tax was cut from 7 per cent to 6 per cent, the sales pace surged to a seasonally adjusted annual rate of nearly 9½ million units, after having fallen off from a very high 9 million in November to 8½ million in December. Of course, the large January gain may have reflected not only some purchases postponed from December but also some speedup in buying in anticipation of the proposed return of the tax rate to 7 per cent. Sales performance over the near term will probably continue to be affected by consumer reactions to developments with regard to the tax.

The brisk advance of aggregate demand late in 1965 was reflected in an acceleration in the uptrend of the Federal Reserve's seasonally adjusted production index. In

December, the index rose by a full 2 percentage points to 148.3 per cent of the 1957-59 average, following a gain of 1.5 points in November. By contrast, the monthly advance had averaged 0.8 percentage point in the eight months of 1965 preceding the early-September steel labor settlement. The sharp December rise in the index reflected widespread output gains. Although the new car assembly rate did not increase further from the advanced November level, output of other consumer goods and of equipment continued to expand. Materials production rose sharply, buoyed by an upturn in steel output following four months of decline from the peak reached last July.

Steel industry analysts are increasingly optimistic over the prospects for significant production gains during the current quarter. It appears that the decumulation of excess steel inventories is virtually completed, and steel users—particularly capital equipment and motor vehicle manufacturers as well as certain defense industries—are entering a growing volume of new orders. Indeed, lead times for some types of steel are reported to be lengthening, and seasonally adjusted steel ingot production rose by a further 8 per cent in January to reach the highest level since last August. The momentum of recent months has been maintained in other industries as well, with expanding defense procurement providing—in an increasingly broad range of industries—additional strength in an already bright demand picture. New orders received by manufacturers of durable goods rose substantially in December to reach a record volume, and the already large backlog of unfilled orders recorded yet another large increase.

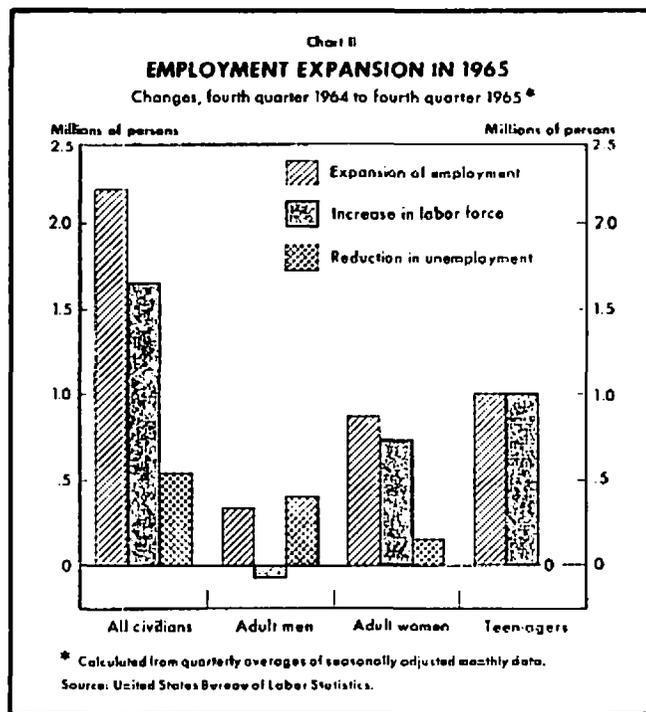
LABOR MARKET DEVELOPMENTS

In response to the pervasive strength in the economy, employment expansion also speeded up in the final months of 1965. The number of persons at work in nonagricultural establishments rose in December by almost 370,000 to reach 61.8 million (seasonally adjusted), following an even larger increase in November. The average monthly gain in the fourth quarter amounted to nearly 350,000 persons, in contrast with a monthly average of about 200,000 in the first three quarters of 1965. The step-up in employment growth late in the year was particularly noticeable in construction—where unseasonably warm weather in some areas was a contributing factor—and in manufacturing. Moreover, the average workweek of manufacturing production workers has lengthened further. Indeed, in both November and December these workers averaged a longer week than at any time since World War II.

Civilian employment as a whole has also been growing at a substantial pace. In January, the over-all unemploy-

ment rate edged down slightly further to reach 4.0 per cent, the lowest reading in nearly nine years. During 1965, the growth in the number of jobholders outpaced the expansion of the labor force by a substantial margin, and as a result the unemployment rate declined from an average of 5.0 per cent in the fourth quarter of 1964 to 4.2 per cent in the fourth quarter last year. Altogether, civilian employment expanded by 2.2 million persons over that one-year period, while the civilian labor force grew by just short of 1.7 million persons. Thus, the ranks of the unemployed shrank by about a half million (see Chart II).

It is noteworthy that the net increase in the civilian labor force was comprised entirely of women and teenagers, whereas the reduction in unemployment consisted very largely of adult men. The total population of adult men (aged 20 and over) expanded only moderately in 1965, and the rise was especially small in the 25- to 55-year-old range, where the proportion of the male population participating in the labor force is highest. Moreover, the number of adult men in the armed forces rose significantly. As a result of these factors, the number of adult men in the civilian labor force actually declined by almost 70,000 between the fourth quarter of 1964 and the fourth quarter of 1965. The net demand for additional adult male employees therefore had to be met by drawing on the un-



employed men already in the labor force. Thus, the number of unemployed men dropped by 25 per cent—from 1.6 million to 1.2 million.

The sizable growth in the number of adult women and teen-agers in the labor force during 1965 was due to the combined effects of population increase and a heavy demand for additional workers. There was a larger rise in the total population of adult women than was the case for adult men, while the teen-age population registered an exceptionally large gain. At the same time, the labor force participation rates of women and teen-agers increased. The rates of these two groups, in contrast with those of adult men, tend to be responsive to over-all demand conditions—rising in good times when the employment situation is favorable and declining somewhat in

periods of slack demand. The growth in the number of adult women and teen-agers in the labor force during 1965 was just about in line with the expansion of job opportunities for these two groups, and there was thus only a relatively small reduction in the number of unemployed women and none at all for teen-agers.

The outlook for 1966 is one of further tightening in the labor market, with only a modest increase expected in the adult male labor force. Moreover, a sizable expansion in the armed forces is planned for this year, which will tend to reduce the availability of additional adult men for civilian employment. Thus, sustained expansion of the economy will in all likelihood result in additional reductions in the number of the unemployed and increasing utilization of women and teen-age workers.