The Business Situation

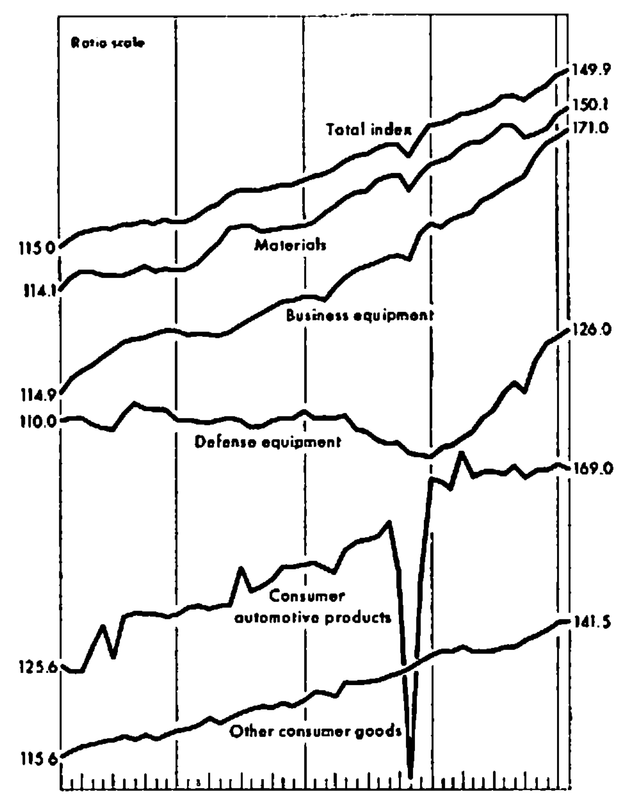
Economic activity has expanded further in the new year, and prospects continue to be for sizable additional gains over the months ahead. The current buoyancy is only in part attributable to the high rate of growth in actual and prospective production of military goods; the economy's strength rests in good measure on a broad civilian-oriented base. A recent survey points to further expansion in consumer demand, and present indications are for sustained strength in business capital spending. Data gathered by the National Industrial Conference Board show continued sizable increases in the volume of capital funds appropriated by leading manufacturers and in the backlog of unspent appropriations. At this point, the major uncertainties respecting the outlook continue to center around the question of the adequacy of the economy's productive resources—both human and physical—to meet the demands likely to be placed upon them. Significant labor shortages already exist in certain industries and regions, capacity utilization rates are high and apparently rising further, and price increases continue to be a matter of concern.

The wholesale price index rose sharply once again in January, reflecting not only further advances for farm products and processed foods but increases in most major industrial categories as well. In February, higher agricultural prices apparently led to another significant increase in the over-all wholesale index. The uptrend in the consumer price level was interrupted in January, when the index of such prices remained unchanged at 111.0 per cent of the 1957-59 average. The over-all stability in January was attributable to Federal excise tax reductions, which resulted in lower prices for new cars, auto parts, and telephone service. Consumer food prices, on the other hand, registered another sharp advance and prices of services also continued to rise. According to Government analysts, the over-all consumer price index would have risen somewhat if the excise tax cuts had not occurred. Those cuts had, of course, only a one-time effect on the consumer price level, and the upward movement of the index was apparently resumed in February.

PRODUCTION AND INVESTMENT

A further substantial advance in industrial output in January pushed the Federal Reserve Board's seasonally adjusted production index up by 1.4 percentage points

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.

to 149.9 per cent of the 1957-59 average (see Chart I). Reflecting the strong uptrend of industrial activity during midwinter, the index rose by a total of just under 5 percentage points between October and January—representing an annual growth rate of more than 13 per cent. The rise in the over-all index in recent months has been broadly based, though the rate of production growth has been slower for consumer goods than for equipment and materials. In January, motor vehicle production schedules were upset by exceptionally bad weather in the midwest and middle Atlantic regions and by a strike at one of the major companies, while the output of apparel was curtailed as a result of the transit strike in New York City. Production of other consumer goods continued to expand, however, with particular strength in color television sets and other home appliances.

In response to the sustained strength of capital spending, the production of business equipment has continued to grow at a rapid rate, with strong gains reported throughout the machinery industries as well as in transportation equipment. Indeed, industry sources report that production of heavy trucks is now running at virtually full capacity, and that total truck output in the first quarter is likely to set a new record. In recent months, the production of defense goods has been rising even more rapidly than has business equipment output. Following a protracted period of virtual stability, defense equipment production turned upward just a year ago, and the advance gathered strength as 1965 progressed. A further increase in January put defense output (according to the derived production index shown in Chart I) at a level about one-fifth above its year-earlier reading.

Fragmentary data suggest that industrial output may have risen further in February, although very poor weather throughout the eastern half of the country slowed production in a number of industries early in the month. The automobile assembly rate, to be sure, registered its second consecutive monthly decline, dropping by about 1½ per cent to a seasonally adjusted annual rate of just over 9 million cars. The February slowdown reflected losses due to bad weather and to the disruptions stemming from a strike at a key plant, as well as the start (on February 21) of a two-week suspension of production at American Motors. Steel output, on the other hand, has moved up further as the demand situation has continued to strengthen. Not only is the decumulation of excess strike-hedge inventories apparently over, but industry reports indicate that, as lead times between order and delivery lengthen for an increasing number of items, some steel users are showing an interest in protecting themselves against the possibility of shortages in the months ahead. For the defense-oriented industries, the near-term production outlook was further improved by a large January surge in the volume of new orders received. Producers in other durable goods industries generally reported that orders in January declined somewhat, but nevertheless exceeded the shipments pace so that the backlog of unfilled orders expanded further.

The over-all pace of inventory investment increased in the latter part of 1965. Revised Commerce Department figures show that the inventory component of gross national product (at a seasonally adjusted annual rate) rose from $7.6 billion in the third quarter to $10.1 billion in the fourth quarter—the highest in nearly fifteen years. Indeed, had it not been for the decumulation of excess stocks of steel, the fourth-quarter rise in inventories would have been even larger. Morever, there are indications of a greater inclination on the part of businessmen to build up inventories against the possibility of shortages or price increases. Nevertheless, the very substantial current and prospective strength of final demands has undoubtedly also been a factor in businessmen's recent decisions with respect to inventories, and inventory-sales ratios in most major sectors of manufacturing and trade have in fact continued to edge generally downward. At the same time, the fourth-quarter increase in the over-all pace of accumulation was centered in agriculture and in nondurables manufacturing and retailing —sectors in which stockbuilding had previously been quite slow by historical standards. Preliminary data for the manufacturing and wholesale sectors indicate that January witnessed a moderate further expansion of inventories.

The generally high rates of capacity utilization throughout the economy, coupled with the good prospects for further demand expansion, provide a strong inducement to the continued growth of business investment in new plant and equipment. Such spending will, of course, ultimately result in an enlargement of the economy's productive capacity. Over the short run, however, a high and rising demand for new plant and equipment will intensify the pressure on productive capacity in the capital goods industries. In this regard, it is noteworthy that the operating rates of both the electrical and nonelectrical machinery industries rose substantially between the end of 1964 and the end of 1965. By last December, the latter industry had attained its "preferred" operating rate of 91 per cent while the former had closely approached its "preferred" rate of 93 per cent.

EMPLOYMENT AND CONSUMER DEMAND

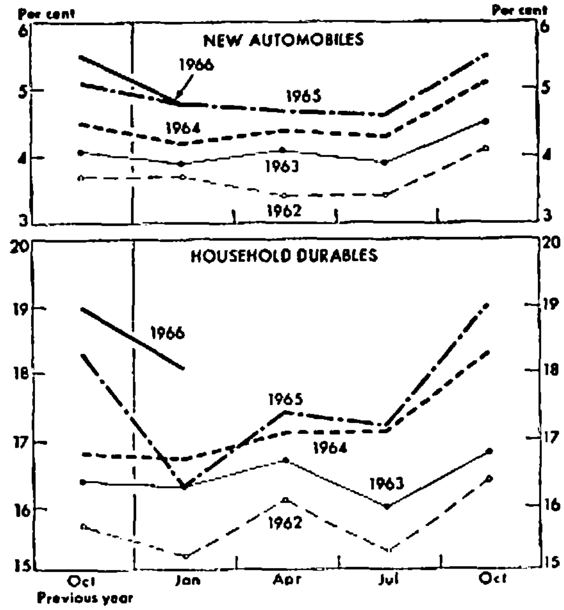
Reflecting the sustained expansion of economic activity, nonagricultural employment recorded further sizable gains in January and February. The increase in each month numbered about 260,000 persons (seasonally adjusted), compared with a 1965 monthly average of about 225,000 persons. The growth pace in January and February was, however, more modest than in last year's fourth quarter, largely because construction employment edged off following a sharp November-December increase. In the manufacturing sector, the employment gains in the first two months of this year continued to be comprised very largely of additions to the blue-collar work force. The growth of manufacturing activity during the past year has resulted in a very substantial expansion of production worker employment. In February, the number of such workers on manufacturers' payrolls was about 5¾ per cent above its year-earlier level, compared with an over-all increase of about 4½ per cent in the other categories of nonagricultural employment. Moreover, manufacturers have also made increasingly heavy use of overtime. The average week put in by factory production workers has lengthened appreciably since last fall, and in February it reached 41.6 hours—the highest since World War II.

The further growth of employment in January provided another boost to wage and salary payments—the largest component of personal income. The net rise in personal income as computed by the Commerce Department, however, was greatly restricted by a sharp jump in social security taxes, which are deducted from earnings in arriving at the income figure. The jump in social security taxes reflected the shift in January to a higher tax rate and to a higher ceiling on the amount of earnings subject to tax. Measured at a seasonally adjusted annual rate, such taxes had risen by about $100 million monthly during 1965; in contrast, the January increase was $2.8 billion. The heavy drag on income growth in January, however, was a one-time phenomenon. While social security taxes will henceforth continue to draw off a larger share of income than they formerly did, their month-to-month increases will again become quite modest.

The reduced rate of income expansion in January may well have been a factor contributing to the drop in retail sales, though losses attributable to the New York transit strike and to severe weather in some regions probably also had an effect. After rising strongly during the final quarter of 1965, sales volume at retail outlets is reported to have dropped by 1 per cent in January. The prospects for consumer demand over the months ahead are bright, however. According to the latest quarterly survey by the Census Bureau, taken in mid-January, consumers' income expectations have improved further and their buying intentions—though down from October, in line with the usual seasonal pattern of this survey—continue to show substantial strength (see Chart II). The proportion of families planning to buy one or more of the seven household durable goods included in the survey, at 18.1 per cent, was significantly above the year-earlier reading of 16.3 per cent. Moreover, the proportion planning to purchase a new car within six months was equal to the figure reported for the corresponding period a year ago. This latter finding is noteworthy in view of the fact that auto-buying intentions in January 1965 were probably inflated somewhat by the responses of persons who, because of shortages resulting from strikes late in 1964, had postponed intended purchases into 1965.

Chart II

CONSUMER INTENTIONS TO BUY NEW AUTOMOBILES AND HOUSEHOLD DURABLES WITHIN SIX MONTHS



Note: Buying plans are expressed as the ratio of the number of families who indicate they intend to buy to the total number of families in the survey.

Source: United States Department of Commerce, Bureau of the Census.