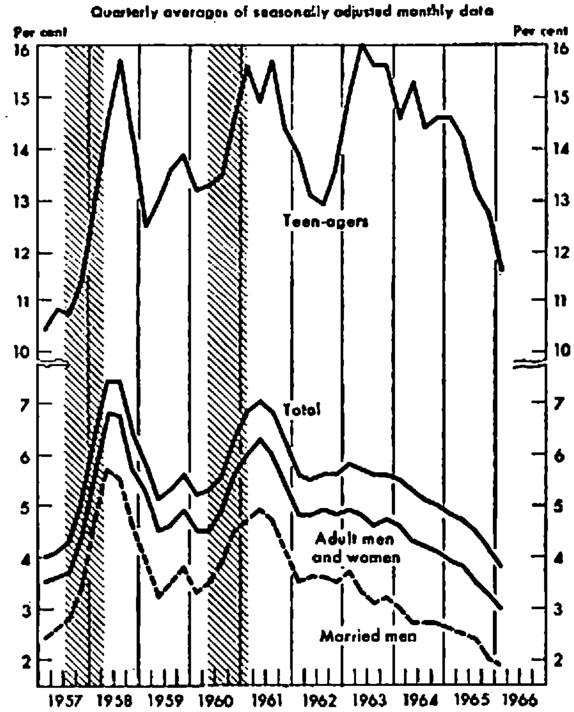
The Business Situation

The economy continues to push ahead into new high ground with undiminished vigor. While the physical volume of goods and services produced and consumed has expanded—and will no doubt continue to expand—this expansion has been accompanied increasingly by price advances, as pressures on the economy's resources have mounted. Thus the exceptionally large dollar increase during the first quarter in gross national product (GNP) reflected not only the continued vigor of growth in real output but also a rather substantial rise in the prices of the goods and services produced.

Chart I
UNEMPLOYMENT RATES
Quarterly averages of seasonally adjusted monthly data



Note: Shaded areas represent recession periods, according to National Bureau of Economic Research chronology.

Source: United States Bureau of Labor Statistics.

Prices normally come under increasing pressure in an economy where mounting demands are pressing against a productive apparatus in which little slack remains. The over-all unemployment rate is down to the lowest level in many years, and even the particularly troublesome teen-age rate has been sharply reduced (see Chart I). Moreover, rates of industrial capacity utilization have edged higher and higher and, against this background, prices of a broad range of goods have risen. The wholesale industrial price index increased at an annual rate of 3 per cent during the first three months of the year, compared with a rise of not quite 1½ per cent during 1965, and it appears that such prices continued to move up in April. The over-all wholesale price index, however, was unchanged in March and perhaps also in April as a result of declines in agricultural prices. At the consumer level, March witnessed another appreciable rise in the over-all price index, reflecting increases for a number of nonfood commodities as well as for foods and services.

Under present conditions, restraint on aggregate demand to keep it in balance with supply possibilities is clearly desirable. With respect to capital spending, there appear to be several factors at work tending to influence businessmen to postpone some of the outlays originally planned for this year. Among these factors, of course, is the President's direct request that businessmen try to cut back on spending wherever feasible. Moreover 1966 capital outlays may be constrained to some degree by the reduced availability and higher cost of credit and, on the supply side, by actual and prospective shortages of capital goods and skilled labor. Nevertheless, while any decisions to postpone some of this year's planned spending will surely be helpful, it remains to be seen how quantitatively important such postponements will prove to be in aggregate.

GROSS NATIONAL PRODUCT IN THE FIRST QUARTER

The Commerce Department's preliminary estimates put GNP at a seasonally adjusted annual rate of $714.1 billion in the first quarter, up by $16.9 billion from the preceding three-month period (see Chart II). This large

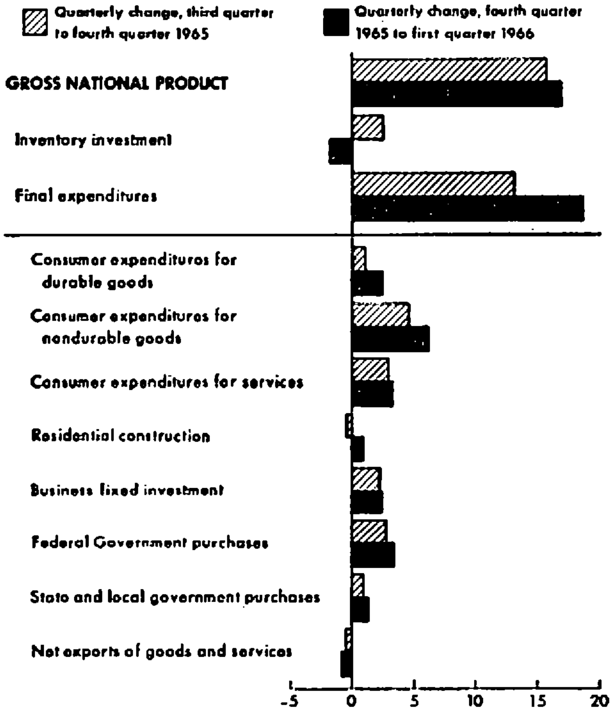


Chart II
RECENT CHANGES IN GROSS NATIONAL PRODUCT AND ITS COMPONENTS
Seasonally adjusted annual rates

Source: United States Department of Commerce.

advance represented an annual growth rate of 10 per cent, close to the highest rate of gain experienced during any quarter of the current business expansion. In real terms, the nation's aggregate output of goods and services grew at an annual rate of slightly more than 6 per cent in the first quarter, somewhat better even than last year's strong rate of expansion. The average price of output rose at an annual rate of around 3½ per cent, however, the sharpest increase in more than eight years and significantly ahead of last year's advance of about 2 per cent. A large first-quarter rise in food prices was an important factor contributing to this step-up in the over-all rate of price increase.

Most of the major components of aggregate demand contributed to the first-quarter GNP increase. Net exports, however, posted their third consecutive quarterly decline, as spending on imported goods and services increased more than did exports of goods and services produced in the domestic economy. The downtrend in net exports is disappointing in view of the important part played by our trade balance in the effort to achieve equilibrium in the over-all balance of payments. Nevertheless, a fall in net exports is by no means unusual in a setting of high and rising levels of production, resource utilization, and income. In addition, a rising domestic price level of course tends to stimulate imports and dampen exports.

The estimated rate of inventory accumulation also slowed down a bit in the first quarter, following a sizable fourth-quarter advance that had pushed the annual rate of accumulation up to an exceptionally high \$10.1 billion. While the \$8.3 billion first-quarter rate was quite large relative to the experience of recent years, it was associated with an exceptionally strong expansion of final demand. Viewed in this context, the accumulation rate does not appear to have been excessive. Nevertheless, a desire to build protection against possible future shortages or price increases may be having an influence on business decisions regarding inventories.

Increased spending for goods and services by all levels of government contributed substantially to over-all demand expansion in the first quarter. State and local government outlays rose by \$1.3 billion, right in line with the average gain recorded last year. Federal purchases, however, registered the largest quarterly advance since the Korean war, and this jump followed a significant rise in the fourth quarter of 1965. The recent speedup in Federal spending reflected the expansion of the armed forces and of military procurement, as Federal nondefense purchases continued to rise at about last year's average rate. Although uncertainty over the future course of events in Vietnam makes forecasting difficult, current estimates nevertheless imply that the push given by defense spending to the expansion of aggregate demand will become more modest in the latter part of 1966.

Consumer spending showed an exceptionally large increase in the first quarter even though the growth of disposable income was slowed by the rise in social security taxes effective January 1. Thus there was a considerable decline in the proportion of disposable income saved, reflecting the fact that it usually takes a while for consumers to adjust their spending habits to changes in disposable income caused by tax changes (including social security deductions). The dip in the saving ratio stemming from the rise in such withholdings may therefore prove to be short-lived. Sharply higher food prices were one factor contributing to the strong rise in consumption spending, and the growth in outlays for nondurables was well ahead of the average pace recorded last year. Spending for durable goods also showed a substantial increase in the first quarter, attributable in good part to very strong sales of new domestically built cars. Sales for the quarter as a whole were at a seasonally adjusted annual rate of 9¼ million units, equal to the high set in last year's first quarter—when the industry was making up sales lost during strikes late in 1964—and substantially above the fourth quarter's 8⅔ million units. Following the strong first-quarter showing, however, sales dropped sharply in April to a seasonally adjusted annual rate below 8 million units.

Spending on residential construction increased in the first quarter by $0.9 billion (annual rate), and thus recouped the declines of the two preceding quarters. The rate of spending nevertheless remained somewhat below the peak attained two years ago. The upturn in the first quarter reflected improvement late last year in the rate of new housing starts, as well as some further rise in construction costs. The starts rate, however, is highly volatile, fluctuating sharply from month to month. Thus, despite the March recovery of starts from the sharply reduced February level, there has apparently been no real breakout from the sideways movement that has characterized this sector over the past two years.

CAPITAL INVESTMENT AND INDUSTRIAL PRODUCTION

The rate of growth in spending for business fixed investment continued to exceed the rate of increase in over-all GNP in the first quarter. As a result, the ratio of such investment spending to total GNP edged up further to reach 10.6 per cent, equal to the highest rates recorded during the investment boom of 1956-57. In dollar terms, business fixed investment spending grew at an annual rate of $2.4 billion in the first quarter, about equal to last year's average quarterly increase. The latest survey of business plans, moreover, clearly supports earlier indications that the remainder of this year will see further strong advances in outlays for new plant and equipment. According to this survey, taken by McGraw-Hill in March, planned 1966 outlays add up to a 19 per cent rise over 1965—an even larger gain than the 16 per cent reported by a Government survey taken in late January and early February. The McGraw-Hill survey, however, was largely completed prior to the President's appeal to businessmen to cut back on the pace of spending this year. Statements by a number of large corporations during the past month suggest that, because of the President's request and also because of delivery delays, some reductions may in fact take place.

The McGraw-Hill survey indicates that manufacturers are devoting an increased proportion of their capital spending to the expansion of productive capacity. During the first four years of the current business expansion, manufacturers' capital investment was heavily oriented toward cost reduction, and capacity growth averaged somewhat less than 4 per cent yearly. As utilization rates moved upward, however, there was a marked shift toward spending for expansion. Thus capacity grew by about 7 per cent last year, and this year's planned gain amounts to 8 per cent.

Reflecting the sustained advance of capital spending, output of business equipment has been growing at a rapid rate for some time and has been an important factor in the over-all expansion of industrial production. Business equipment production increased again in March, as did all the other major categories of industrial output. The Federal Reserve Board's seasonally adjusted production index rose by a substantial 1.5 percentage points to reach 152.9 per cent of the 1957-59 average. The March showing rounded out a very strong quarter. Indeed, industrial output increased during the first quarter at an annual rate of more than 11 per cent, one of the highest growth rates recorded for any quarter of the current business expansion.

Scattered data suggest that the over-all pace of output growth may have slowed a bit in April. A strike at one company cut steel output somewhat, though total ingot production (seasonally adjusted) was up for the fifth consecutive month. Auto assembly operations early in the month were hampered by a railroad strike, and the resulting production losses were a factor in the decline in the assembly rate—to about 9.1 million units, in annual terms, compared with 9.4 million in March. Moreover, April output in the mining sector was significantly dampened by the widespread strike of coal miners. On the other hand, new orders for durable goods moved sharply higher in March and the backlog of unfilled orders registered a very substantial further increase.