

## The Business Situation

Recent economic developments have underscored the basic strength and momentum of the business expansion. At the same time, however, it is becoming increasingly clear that inflationary pressures are continuing to intensify. In view of the critical importance of price stability in achieving long-term economic growth and the urgent need to maintain and improve our international competitive position, it is evident that inflation has again become one of the nation's most pressing economic problems.

Industrial output climbed strongly in July, and the large and rising backlog of orders in manufacturing provides a basis for further growth of production in the months ahead. The strength of consumer demand was clearly demonstrated by a further advance in retail sales in July, following the sharp June recovery, and by a recent survey of consumer buying intentions indicating that overall plans to purchase major durable goods remain well above the high year-ago level. Business spending on productive facilities continues at the rapid pace forecast earlier in the year, and a recent survey by the National Industrial Conference Board shows that appropriations for capital expansion by large manufacturing firms moved up sharply in the second quarter. Outlays for inventories by manufacturing firms also continue to increase strongly. While Federal defense spending remains one of the most uncertain elements in the outlook for aggregate demand, the buildup of military forces already in process is likely to result in a continued sharp uptrend in defense spending well into 1967.

Residential construction continues to be the only major sector of the economy exhibiting significant weakness. Housing starts have declined steadily since the beginning of the year. Other types of construction remain strong, however, especially industrial and public building. Thus, while employment in residential construction has eased in certain regions, some of the resources released by the decline in residential construction are being absorbed into other types of building activity. Moreover, residential building should be stimulated by the implementation of pending legislation designed to increase the mortgage purchase and lending authority of the Federal National Mortgage Association by as much as \$4.7 billion.

In the face of tight labor markets and high-level utiliza-

tion of production facilities, the price level continues to reflect demand pressures. Consumer prices again rose sharply in July, while at the wholesale level prices of farm products and processed foods moved upward substantially, following several months of declines. Industrial wholesale prices also increased further, although at a pace slower than in the first half of the year. Furthermore, the recent rise in consumer prices—notably the prices of food and services—has added to the wage demands now being pressed in collective bargaining. Management may find it hard to resist these demands in view of the high level of profits and substantial backlogs of orders. Indeed, the settlement recently concluded in the airline strike, apparently calling for annual increases in wages and fringe benefits more than half again as large as the Administration's 3.2 per cent guideline for noninflationary wage increases, underscores the developing dangers of cost inflation.

### PRODUCTION, ORDERS, AND BACKLOGS

The Federal Reserve Board's seasonally adjusted index of industrial production advanced by a substantial 1.3 percentage points in July to 157.5 per cent of its 1957-59 average, despite a 10 per cent decline in the output of automobiles. Excluding the automotive component of the index, industrial production climbed 1.8 percentage points for the largest monthly advance since February.

The July gain in total production included a substantial further expansion in the output of defense materials and business equipment, reflecting the continuing military buildup and the persistent growth of business capital spending. Increases in output were also widespread among producers of both durable and nondurable industrial materials. Output of iron and steel turned up after a two-month decline, and new orders booked by steel mills for September and October show increases among a wide range of users, including automobile manufacturers.

Among the other major market groupings in the industrial production index, the output of finished consumer goods remained roughly unchanged as declines in automobiles and some other major durable goods were offset by increases in the production of consumer nondurables. The

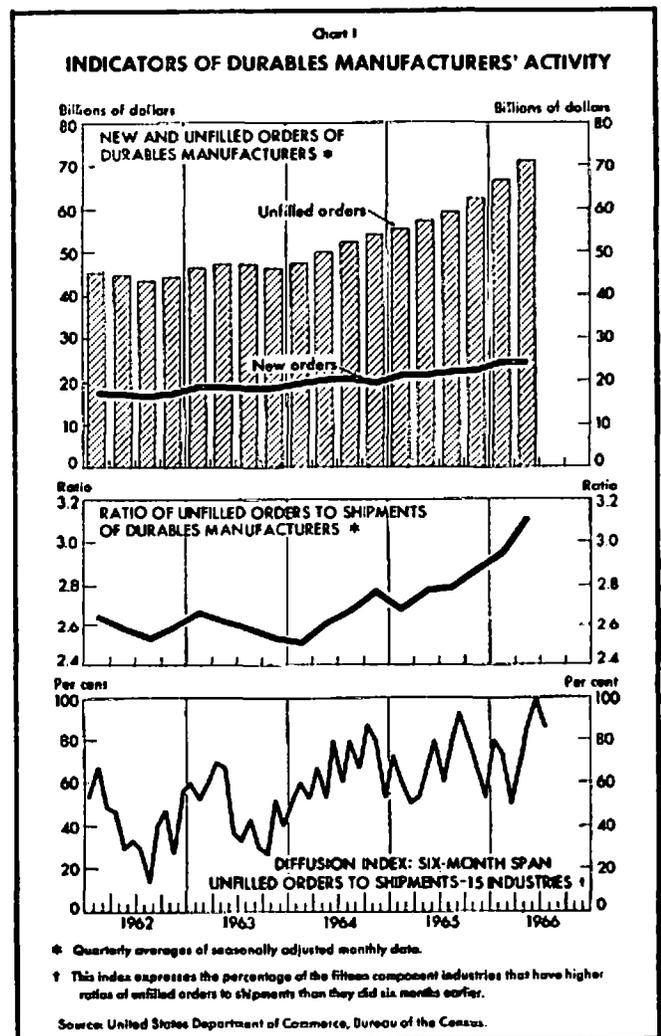
recent slowdown in the output of consumer durables may well have been a delayed reaction to the spring decline in retail sales of these items, and it should be noted that retail sales have since rebounded strongly.

The July advance in manufacturing production was at a seasonally adjusted annual rate of 10 per cent, somewhat above the average rate of expansion of manufacturing capacity indicated for 1966 as a whole by the spring McGraw-Hill survey. The average capacity utilization rate is already at 93 per cent for manufacturing firms, and a continued gain in production on the order of July's performance would be likely to place considerable further strain on the nation's productive facilities.

Recent data on new orders suggest continued strong advances in industrial production. New orders received by manufacturers of durable goods in the second quarter rose to a record seasonally adjusted quarterly average of well over \$24 billion (see Chart I). New orders in July were down slightly from this level, as decreases in automobile and aircraft orders more than offset advances in other industry groups. However, the volume of new bookings remained well above the July rate of shipments, and backlogs of unfilled orders piled up further among a wide range of durables industry groups. The total order backlog has risen sharply and steadily since early 1964, following a period of more moderate growth earlier in the expansion. The ratio of unfilled orders to shipments of durables (also shown on the chart) is now at its highest level since November 1959, with the present backlog equivalent to more than three months of shipments at the current rate.

The figures on total unfilled orders and total shipments of durables manufacturers have been subdivided into fourteen industry groups and an "all other" category. These industry data are useful in assessing the extent to which order backlogs are concentrated within or diffused throughout the durables manufacturing sector. The bottom panel of Chart I depicts the proportion of the fifteen industry groups that in any given month had unfilled-orders-to-shipments ratios above those six months earlier. This chart shows that the recent advance has been very widespread indeed. Whereas the proportion of industries experiencing increases in their unfilled-orders-to-shipments ratios fluctuated widely during 1962 and 1963, the proportion passed the 50 per cent mark at the beginning of 1964 and trended upward thereafter. July data indicate that the ratio of backlog to shipments in thirteen of the fifteen component categories is higher than it was six months earlier.

Thus, in contrast to earlier years of the current expansion when the existence of relatively low order backlogs and a sizable margin of unutilized capacity enabled durable goods

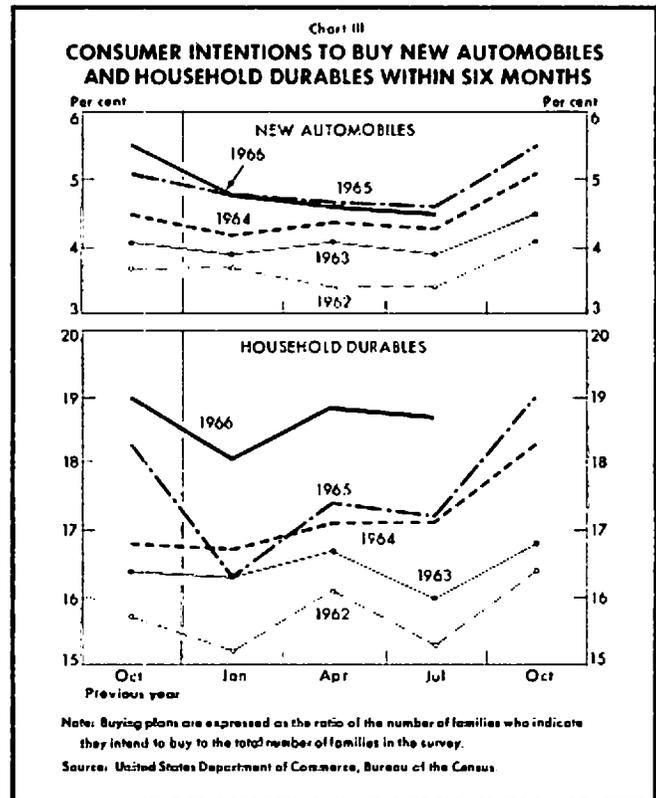
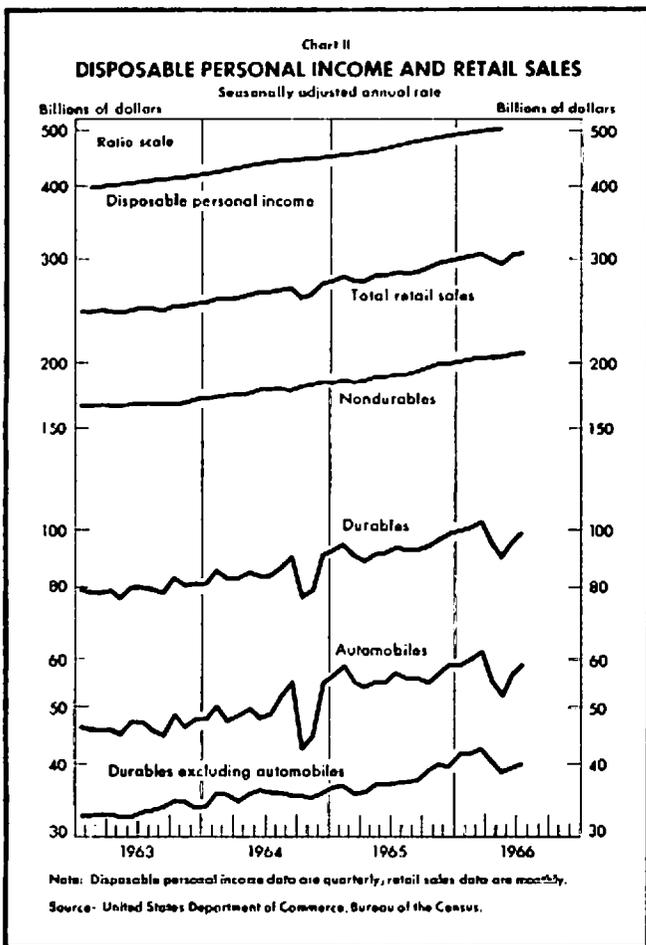


producers to accommodate increases in orders without substantial increases in delivery times, over the past two and a half years the proportion of firms operating at or near preferred capacity rates has risen markedly and order backlogs have grown substantially. This situation threatens to lead to greater price pressures, production bottlenecks, and shifting of orders to foreign producers than has been the case in the past.

#### CONSUMER DEMAND

Preliminary data indicate that retail sales (seasonally adjusted) rose 0.6 per cent in July, reaching an annual rate of \$306 billion, only \$300 million below the record set in March (see Chart II). This advance followed a sharp re-

covery in June which, on the basis of upward revised data, came to 3.6 per cent. Much of the pickup in June was attributable to increased purchases of automobiles following the April and May slump, while slightly more of the July advance was accounted for by other consumer durables. Although a part of the recent increase in retail sales reflects higher prices on many items, especially food, it nonetheless appears that real demand has increased also. Much of the adjustment of consumer spending to earlier increases in social security taxes and higher withholding rates has probably already been accomplished, and consumer buying is now moving more closely in line with the rising trend in personal incomes. Total personal income rose strongly in July as Federal pay increases went into effect. The advance in wages and salaries was the largest since February, and would have been even greater but for the earlier than usual shutdown for model changeovers in the automobile industry and the machinist strike at some airlines.



The prospect for automobile sales remains the foremost uncertainty in the outlook for consumer spending. While dealer sales of new cars averaged 8.3 million units in June and July, up sharply from the low May level of 7.3 million, it is not clear how much of this improvement has resulted from the intensive efforts of dealers to reduce their large stocks of 1966 models. Nonetheless, the automobile industry itself is expecting some further gains in sales during the remainder of this year. The most recent survey of consumer buying intentions, taken in mid-July, indicates that the proportion of families planning to purchase a new car within six months was roughly the same as last year's reading (see Chart III). The proportion of families intending to buy one or more of the seven household durables included in the survey was substantially higher than a year ago, indicating that the consumer durables sector could make a further sizable contribution to expanding demand in the months ahead.

**EMPLOYMENT, WAGES, AND PRICES**

The overall unemployment rate in August remained at the July level of 3.9 per cent of the civilian labor force, with

a slight increase in the rate of unemployment among adult women, a further decline among teen-agers, and no change for married men. The August figures reflect a gain in total employment roughly equal to the moderate advance in the civilian labor force. Even with the August increase, however, the growth of the civilian labor force this year has been sluggish. In the first eight months of 1966, the labor force has expanded by only three fourths the rate in the comparable period of 1965. It had been expected that labor force growth this year would be quite substantial, reflecting both demographic factors and the usual tendency for high-level economic activity to induce many persons into the labor force who otherwise would not enter the job market. Nevertheless, this expected strength in the civilian labor force did not develop due to such factors as the buildup in the armed forces, a larger than usual number of students remaining in school, inclement weather conditions that reduced employment in agriculture, and strikes in the construction and airline industries. The relatively slow growth of the labor force has been one of the factors tending to maintain the heavy pressures on the available labor supply.

A recent Labor Department report indicates that annual wage increases (excluding fringe benefits) in agreements involving 1,000 or more employees concluded in the first half of 1966 will average 3.7 per cent over the life of the contracts. Comparable negotiated wage increases averaged 3.3 per cent in 1965, 3.0 per cent in 1964, and 2.5 per cent in 1963. Moreover, the higher gains cited for the first half of this year exclude settlements in the construction industry, where increases have been especially large—averaging about 6 per cent a year during the first half of 1966. The prospect for still higher wage demands and settlements in coming months may have been influenced by the well-publicized settlement in the airline industry which involves, in addition to a large pay increase, a provision for cost-of-living adjustments. Furthermore, many important wage contracts are coming up for negotiation over the next twelve months.

The price picture remains highly disturbing. The consumer price index rose once again in July, although the advance in the food component was less than seasonal. Prices also mounted further at the wholesale level. The prices of farm products, which had leveled off in the early summer, jumped 3.4 percentage points in July for the largest monthly increase since March 1960. Part of the

advance may be reversed as some commodities—such as eggs and livestock—resume their normal flow to market after being held up somewhat during the hot weather experienced in June and July in some regions of the nation. A large part of the price rise is likely to be sustained, however, as the spring drought and the prolonged heat wave have cut yield prospects for many types of grain crops and pasture feeds, especially in the south central and Atlantic seaboard states. Industrial wholesale prices also moved upward in July at a seasonally adjusted annual rate of 2.3 per cent, somewhat below the average monthly advance for the first half of the year. Against the background of rising demand and the possibility of large increases in future wage settlements, price pressures are likely to remain a problem in the months ahead.

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AND  
MONEY: MASTER OR SERVANT?**

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