# The Business Situation

The recent moderation of demand pressures is apparently continuing. Nevertheless, with defense expenditures pointed upward, the economy still faces the problem of excess demand. Unemployment remains at a very low level and skilled labor is in short supply, while industry is operating close to capacity. Even though industrial wholesale prices have been stable since the summer, consumer prices have increased further, labor costs per unit of output have risen sharply, and wage pressures have accelerated.

Although retail sales have remained on a high plateau for some months now, there is considerable buoyancy in the economy. Disposable income is rising very rapidly, industrial production has apparently resumed its upward course after a temporary pause in September, and new orders received by durables manufacturers remain extremely high. New survey information on the spending plans of consumers and businesses, while suggesting slower growth in such spending, nevertheless underscores the basic strength of the private sectors of the economy. Businesses expect to increase their spending on plant and equipment still further in the first half of 1967. Consumer intentions to buy new automobiles and major household durables within the next six months have weakened perceptibly, perhaps as a consequence of uneasiness about the economic outlook, but consumers remain optimistic about the growth of their incomes, which is the prime determinant of consumer demand.

## PRODUCTION, ORDERS, AND CONSTRUCTION

Industrial output rose in October, after the pause recorded in the preceding month. The Federal Reserve Board's seasonally adjusted production index advanced by 0.5 percentage point to 158.6 per cent of the 1957-59 average. The most recent increase was moderate in comparison with the average gains experienced earlier this year, extending the gradual trend toward a more sustainable rate of growth of production. Thus, while industrial output rose at an annual rate of 14 per cent from the fourth quarter of 1965 to the first quarter of 1966, the annual rate of increase dropped to 8 per cent in the second quarter and to 5½ per cent in the four-month July to October period. The slowdown in the growth of production has been especially marked in the consumer goods sector, where automobile assemblies and the production of television and radio sets trended downward. The production of materials has also weakened. Business and defense equipment output, on the other hand, has continued to increase at a very rapid rate throughout the year, as investment outlays remained on their steeply rising curve and the military requirements for the Vietnam war mounted sharply.

These longer run trends were, by and large, also reflected in the results for the month of October. A notable exception was the steep 20 per cent rise in automobile production from depressed September levels to a rate almost as high as that of the exceptional first quarter. In November, however, the rate of auto assemblies was reduced somewhat. On the other hand, the October output of furniture and some household appliances declined again, while equipment output, for both business and defense purposes, continued to advance. Finally, materials production declined slightly further as iron and steel output moderated for the third consecutive month.

The overall volume of new orders received by durables manufacturers fell by \$1.2 billion to a \$24.1 billion seasonally adjusted total in October, after increasing by \$1.8 billion in September. Much of the fluctuation in new orders in recent months has been ascribable to defense orders. New durables orders for civilian goods, after declining substantially from March through August, apparently rose in both September and October. Shipments by all durables manufacturers increased in October to a new record but still fell short of new orders bookings. Consequently, the backlog of unfilled orders rose once more, although the October increase of \$600 million was one of the smallest recorded in the past year.

Construction outlays continued to decline in October, with the bulk of the easing again concentrated in private residential construction, which fell by 2.7 per cent. While the most recent declines in both total and residential construction outlays were considerably smaller than those occurring in the preceding three months, some further easing, especially in residential construction, seems highly likely. Thus, private nonfarm housing starts dropped by 21 per cent in October, and residential construction awards were off by 5½ per cent. New contracts for commercial and industrial construction, which had risen substantially in September, fell off by even more in October and were 5 per cent below their year-ago level.

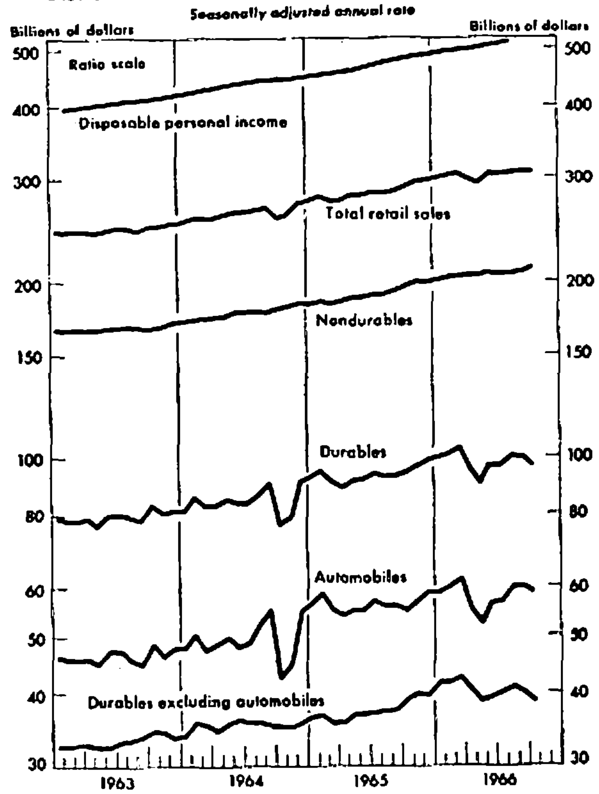
### INCOME, SALES, EMPLOYMENT, AND PRICES

Personal income, which advanced strongly in September at a time when other indicators were showing some hesitancy, registered another substantial increase in October. A further large rise in Federal transfer payments, under Medicare and other programs, brought the increase in total personal income to a seasonally adjusted annual rate of $4.6 billion, equaling the September gain and only moderately below the August advance of $5.4 billion. There has been a marked acceleration of the growth of personal income during the last three months to an annual rate of 10 per cent, compared with less than 7 per cent from December to July. This development reflects in part the fact that Medicare payments have recently boosted income. The rapid pace of advance in wage and salary disbursements, which account for some two thirds of total personal income, has continued unabated.

Chart I

DISPOSABLE PERSONAL INCOME AND RETAIL SALES

Seasonally adjusted annual rate




Note: Disposable personal income data are quarterly; retail sales data are monthly.

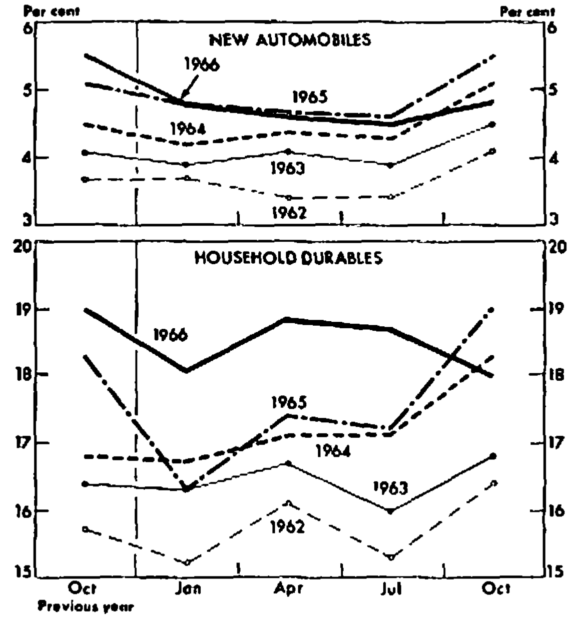
Source: United States Department of Commerce, Bureau of the Census.

Retail sales rose slightly in October, according to preliminary data, following a moderate seasonally adjusted increase of 0.3 per cent in September (see Chart I). In both months, declines in the sales of durable goods stores were more than offset by increased sales at nondurable goods outlets. Within the durables category, sales of furniture and household appliances were down in October for the second consecutive month, at least partly due to the slump in residential construction, and automobile dealers reported a substantial drop in new car sales. Domestic new car sales declined to a seasonally adjusted annual rate of slightly over 8 million units during October, down from 8.6 million in September and the lowest level since last May. Dealer sales recovered to 8.4 million units in November, but still remained below previously anticipated levels. As a consequence, auto producers have cut back their November assemblies by 6 per cent to a seasonally adjusted annual rate of 8.5 million units; 8.8 million units are scheduled for production in December.

The latest survey of consumer buying intentions points to the possibility of a continuation of somewhat less buoyant auto sales in the coming months. In October of this year, the proportion of families reporting plans to purchase a new car within six months was lower than in either October 1965 or October 1964, but still well ahead of the percentages in earlier years (see Chart II). The percentage of families planning to buy a new car within three months, however, was about the same as in the preceding two October surveys, and the overall decline was almost entirely in plans for purchases three to six months in the future, or at some as yet undecided time within the six-month period. There are a number of reasons which might explain this divergence. First-quarter automobile sales were exceptionally strong in 1965, when consumers were purchasing the cars that had not been available during the preceding strike period, and in 1966 when purchases soared in part as a result of the reduction in the automobile excise tax. (This excise tax cut was repealed in March 1966.) The strength of buying intentions revealed by the 1964 and 1965 October surveys

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.

is undoubtedly explained to a large extent by these factors, and some letdown is hence not very surprising. The latest survey, however, may also denote a feeling of uneasiness about the economic outlook beyond 1966, and perhaps also the expectation of an income tax increase early next year.

These factors are apparently also reflected in the buying plans for household durables. Indeed, while the proportion of families intending to purchase within three months one or more of the seven big-ticket items included in the survey was virtually unchanged from the high percentages of October 1965 and 1964, the proportion planning to buy in three to six months, or at an undetermined point within the coming six months, dropped sharply below the levels of the last two years. The survey also disclosed that the proportion of families expecting to have higher incomes a year from the survey date had remained as large as it was in October 1965, and considerably ahead of the percentages recorded in the preceding years. Since income is the main factor determining how much people will buy, the apparent contradiction between income expectations and purchase plans might be a further evidence of consumer uneasiness regarding business prospects.

The expectations of further rises in personal income revealed by the survey may have been based in part on the very strong employment conditions that prevailed during the past year. The situation remained taut in this respect during November, when employment rose substantially and the overall unemployment rate fell by 0.2 percentage point to 3.7 per cent. This level has already been reached twice early this year, but was otherwise the lowest in thirteen years. The unemployment rate for married men, at 1.7 per cent, hit its lowest level on record.

The continued tightness in the labor market, along with substantial increases in the cost of living, has generated strong pressures on wages. The median wage increase provided for in major labor contracts negotiated in the first nine months of each year has risen sharply during this expansion from only 2.3 per cent in 1963 to 3.0 per cent in 1964, 3.3 per cent in 1965, and 3.8 per cent in 1966. This trend, furthermore, appears to be continuing, and could easily lead to a serious problem of cost inflation. Labor costs per unit of output in manufacturing have risen steeply since the summer—at an annual rate of 8 per cent in the last two months alone—and are likely to keep on increasing since smaller productivity gains are likely to continue. This, of course, creates a grave threat both to the future of the expansion and to the efforts to bring our balance of payments into equilibrium.

Meanwhile, the prices paid by consumers have been advancing month after month at a rate not matched since the inflationary bout of the midfifties. The October rise in the consumer price index was 0.4 per cent, bringing it to a level fully 3.7 per cent above a year ago. Prices of food in grocery stores declined slightly in October, although less than seasonally, but the prices of all major nonfood categories increased. The prices of services, in particular, continued on their upward trend, and nonfood commodity prices rose once more. Apparel prices increased again, and the prices of new automobiles jumped in October, in large part because in September dealers had extended substantial discounts on 1966 models. Taking new safety features and other quality improvements into account, the prices of 1967 models are estimated to average about the same as the prices for 1966 model cars at the time of their introduction.

## BUSINESS INVESTMENT

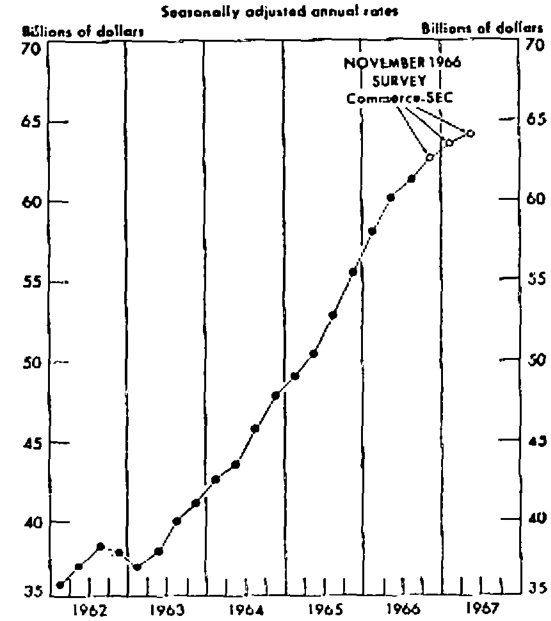
Recent survey data suggest the probability of some slowdown during 1967 in the rate of growth of business spending on plant and equipment, but next year's growth is nonetheless likely to be substantial.

The Department of Commerce-Securities and Exchange

Commission survey of plant and equipment expenditures taken in November indicates that businesses are now expecting to spend \$63¾ billion (seasonally adjusted annual rate) in the first half of 1967, or some 8 per cent more than in the corresponding period of 1966 (see Chart III). While such a growth rate is appreciable, it nevertheless falls well short of the gains achieved in the preceding three years. The slightly downward-revised estimates for 1966, for instance, place this year's advance over 1965 at fully 16½ per cent. Businesses, moreover, apparently plan smaller increases in plant and equipment expenditures in the second quarter of 1967 than in the first.

Chart III

PLANT AND EQUIPMENT EXPENDITURES




Sources: United States Department of Commerce; Securities and Exchange Commission.

The slower growth anticipated for the first half of next year by the Commerce-SEC survey is not inconsistent with the earlier McGraw-Hill fall survey of preliminary plans for capital spending. The latter survey found that businesses are currently planning to spend \$63.8 billion during the entire year 1967, or 5 per cent more than this year. The current plans of businessmen covered in this survey are, of course, subject to continuous revision as the new year unfolds. Throughout this expansion, such revisions have been considerable and in each year on the upside. There are, however, a number of forces now at work to slow down the capital spending boom and, if the plans for 1967 revealed by the McGraw-Hill fall survey are upgraded, it may consequently be by a lesser amount than in the past years of the expansion.

Indeed, the rapid increase of corporate profits and corporate cash flow has halted since the spring of this year. After-tax profits remained unchanged in the second quarter at \$48.7 billion (seasonally adjusted annual rate) and then declined slightly to \$48.3 billion in the third quarter, partly as a reflection of lower sales by automobile producers. Thus, even though corporate capital consumption allowances continued to rise steadily while dividend payments advanced only slightly in the second quarter and not at all in the third, the increase in corporate cash flow slowed down, and the third-quarter gain—\$0.2 billion to \$66.3 billion—was extremely small. Although both profits and cash flow remain at historically high levels, their near stability, coupled with tight credit conditions, places a damper on the increase in the capital spending of many firms. At the same time, the very rapid rate of capital expansion of the last three years has helped relieve capacity pressures in a number of industries (although the overall capacity utilization rate, newly published in the *Federal Reserve Bulletin*, has remained unusually high throughout 1966). In addition to these forces, the recent suspension until 1968 of the tax credit on new machinery and equipment and of accelerated depreciation on new business structures has also helped postpone investment plans. The McGraw-Hill survey indicates that plant and equipment spending plans for 1967 were cut back by as much as \$1½ billion because of these fiscal measures, which thus reduced next year's planned increases in capital outlays by fully one third.

A survey of the capital appropriations of the 1,000 largest manufacturing corporations recently conducted by the National Industrial Conference Board seems to confirm the expectation of a slower growth in capital spending in 1967. Net new capital appropriations, which had risen by 14 per cent in the second quarter of the year, declined by 16 per cent in the third quarter, but still remained very high. Even though actual capital expenditures by these large corporations rose to record levels in the third quarter, they were nevertheless again lower than net new appropriations. The backlog of unspent authorizations consequently increased, albeit by a relatively small amount.