The Business Situation

Demand pressures at the close of 1966 were distinctly more moderate than was the case earlier in the year. A year ago, personal consumption expenditures, business capital outlays, and defense requirements were all rising rapidly, threatening to reach levels well in excess of the practical limits of available labor and capital resources. In such circumstances, it was to be expected that inflationary pressures would be set in motion, as clearly happened in the first half of 1966. By the year-end, however, efforts to combat inflationary excesses had succeeded in dampening the rate of growth of overall private demand, thus helping to make available the resources necessary for increased defense production while at the same time providing some measure of relief in the overall call made on the nation's production capacity.

Although recent estimates of gross national product (GNP) in the fourth quarter of 1966 indicate a rate of gain higher than that of the third quarter, this development primarily reflected a sharp increase in the rate of inventory accumulation. Final expenditures—GNP less inventory investment—actually grew more slowly in the fourth quarter than in the third. Defense expenditures expanded a little less rapidly but still accounted for about one fourth of the advance in total GNP. Increases in capital spending by business, although still considerable, took a smaller share of the total expansion of output than in earlier quarters of the year. Consumer spending advanced relatively little, despite a substantial increase of disposable personal income, and residential construction outlays dropped further. In the meantime, however, there are indications that the residential construction decline may soon bottom out.

Total industrial production rose from the third to the fourth quarter of the year at a comparatively modest annual rate of 2¾ per cent. At the same time, the rate of utilization of manufacturing capacity, while remaining at a high level, edged off slightly in the fourth quarter. The average workweek in manufacturing also shortened somewhat in December.

Despite some reduction in overall demand and supply pressures, production costs continue to increase and presently show little prospect of easing. Unit labor costs in manufacturing are estimated to have risen at a 6 per cent annual rate from July to December. Moreover, the GNP deflator—the broadest measure of price changes in the economy—rose at an annual rate of more than 3 per cent during the fourth quarter, somewhat less rapidly than the 3¾ per cent rate registered earlier in the year but almost twice as fast as in 1965.

GROSS NATIONAL PRODUCT IN THE FOURTH QUARTER OF 1966

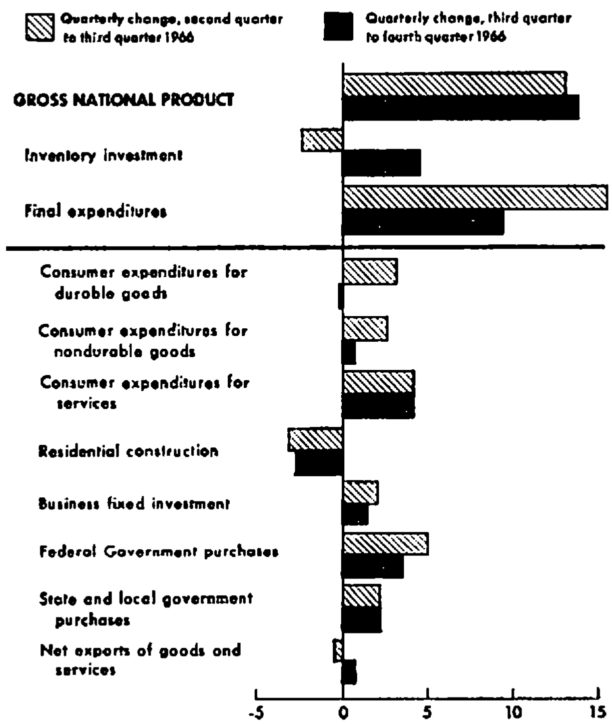
The nation's total output of goods and services increased by $13.8 billion in the final quarter of 1966, to a seasonally adjusted annual rate of $759.1 billion, according to preliminary estimates by the Department of Commerce. This sizable advance—at an annual rate of 7½ per cent—was somewhat larger than that of the preceding three-month period, although it fell well short of the outsized increase recorded during the first quarter of 1966. Of the $13.8 billion added to GNP during the fourth quarter, however, only some $8 billion constituted a real increase in goods and services produced; the remaining $5¾ billion reflected merely higher prices. Nevertheless, even when adjustments are made for price rises, the growth in GNP was at a strong annual rate of nearly 4½ per cent, compared with 4 per cent in the third quarter, 2 per cent in the second, and 6 per cent during the exceptional first quarter of 1966.

About one third of the increase in GNP during the fourth quarter was due to inventory accumulation (see Chart I). Inventories are estimated to have risen at an unusually high annual rate—$14.4 billion—with sharp rises recorded in work-in-process inventories held by durables manufacturers, notably in the machinery and transportation equipment industries. But manufacturers' inventories of finished goods also increased rapidly, as did wholesale and retail trade inventories. In contrast, final expenditures

Chart I

RECENT CHANGES IN GROSS NATIONAL PRODUCT AND ITS COMPONENTS

Seasonally adjusted annual rates



Source: United States Department of Commerce.

—total GNP less inventory investment—rose by a relatively modest $9.3 billion, which was considerably below the $15.4 billion increase recorded in the preceding quarter.

The consumer sector showed a distinct lack of buoyancy during the fourth quarter, and the $4.5 billion increase in total outlays for consumption was only half the gain of the preceding quarter. In real terms, the fourth quarter's advance in total consumption expenditures was negligible—$0.2 billion, as against a $6.9 billion gain in the third quarter. Consumer spending for durable goods declined fractionally during the fourth quarter, and was actually slightly less than in the opening months of 1966. Outlays for automobiles and parts, although virtually unchanged from the third-quarter level, were significantly lower than at the start of the year. Expenditures on nondurable goods did increase, but the advance was the smallest in three years and was more than accounted for by higher prices. Consumers increased their expenditures for services by as large a dollar amount as in the third quarter, but almost two thirds of the increase went simply to pay for higher costs.

The slowing of consumer spending seems not to have reflected a general lack of funds. Indeed, disposable personal income in the fourth quarter expanded at a very rapid $10.4 billion seasonally adjusted annual rate, compared with a $7.9 billion gain in the preceding quarter. At the same time, while outstanding consumer credit advanced less rapidly in the fourth quarter than in the third, the availability of such credit appears to have been maintained, if not increased a bit. The recent small increases in consumer outlays on goods and services have apparently resulted from a number of causes, including a growing uneasiness among the general public, prompted by uncertainty regarding the economic outlook, price developments, the war in Vietnam, and the possibility of a tax increase. It should also be stressed, however, that the slower rise of consumption than of disposable personal income in the fourth quarter may simply have reflected the desire of consumers to increase the proportion of their income saved. During most of the current expansion, consumers have been saving an unusually small share of their disposable incomes. This development, which in the last year or two probably reflected in good part efforts to maintain an advancing standard of living in the face of rapidly rising prices, had brought the savings rate down to an exceptionally low level by the third quarter of 1966. In the fourth quarter, however, the savings rate returned to a figure more in line with the long-term average.

Residential construction expenditures again fell sharply in the fourth quarter—by $3 billion—to a level one-fourth below that of the first quarter of 1966. At the same time, however, housing starts and other indicators of prospective home-building activity improved somewhat during the period, leading many observers to conclude that the decline in home building might be nearing an end.

Business fixed investment outlays increased less in the fourth quarter than in the third, but the $1.4 billion advance nevertheless remains large by historical standards. The survey of plant and equipment expenditures taken last November by the Department of Commerce and the Securities and Exchange Commission had already revealed that capital spending was increasing at a lesser pace during the fourth quarter, and indicated that further slowdowns in such spending were likely in the current and following quarters. There are a number of factors behind this leveling off. Perhaps the main one is that the pace of economic activity has begun to moderate, while the pressure on capital resources is easing slightly as new capacity created by past spending comes into use. The Federal Reserve Board's index of capacity utilization edged off by 1 percentage point during the fourth quarter, to the still very high level of 90 per cent. At the same time, profit margins have come under progressively stronger pressure as labor costs per unit of output mount rapidly.

National defense expenditures rose steeply in the fourth quarter, by $3.5 billion, following an even sharper upsurge of $4.9 billion in the preceding quarter. By the end of the year, defense spending was $13 billion higher than in the fourth quarter of 1965, while for the full year 1966 the advance over the preceding year amounted to $10 billion. Federal Government purchases of nondefense goods and services, on the other hand, did not rise during the fourth quarter.

The budget recently submitted to Congress calls for further substantial increases in Federal Government purchases of goods and services. In his *Economic Report,* the President stated that defense expenditures would rise by another $10 billion during calendar year 1967, while all other Federal purchases would increase by $1½ billion. Because of the stimulus of Government spending and a basically strong private demand situation, the Council of Economic Advisers expects that the economy will continue to move ahead in 1967 and will gather strength after midyear. This projection assumes, it might be noted, that Congress will act favorably on the President's budget plans, including the proposed imposition of a 6 per cent surcharge on both corporate and personal income taxes. The surcharge would be introduced on July 1 and, according to the President, would "last for two years or for so long as the unusual expenditures associated with our efforts in Vietnam continue".

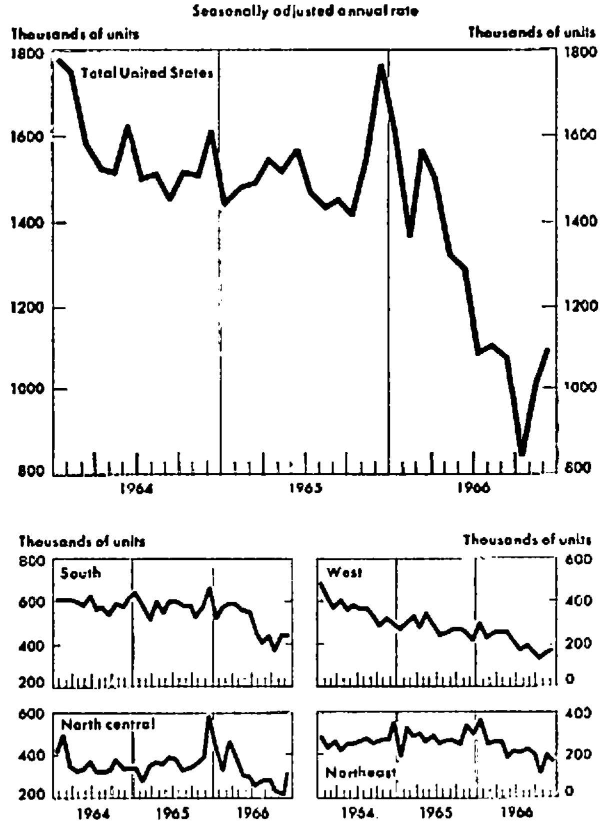
RECENT DEVELOPMENTS

According to the preliminary estimate, industrial output remained virtually unchanged in December. The Federal Reserve Board's index edged up by 0.1 percentage point, to 158.7 of the 1957-59 average, after having eased by 0.2 percentage point in November. As in the past few months, there was a substantial decline in iron and steel production but large increases in the output of business and defense equipment. Automobile production, on the other hand, remained at a seasonally adjusted annual rate of 8½ million units in December but declined to a 7¼ million unit level in January. Mining output rose substantially, reflecting primarily a sharp recovery in coal production, while utilities production also increased.

Manufacturers' shipments, which had declined slightly in November, rose more than 2 per cent, or by $1.0 billion, in December. Considerable strength was apparent in both the durables and nondurables components. Equipment and defense producers, as well as manufacturers of consumer nondurables, had particularly large increases in sales. Along with the strong performance of shipments, the increase in manufacturers' inventories moderated substantially in December, amounting to $0.8 billion after seasonal adjustment, as against a $1.1 billion advance in November. The rise in durables manufacturers' inventories, in particular, slowed to $0.6 billion from $1.0 billion in the preceding month. The overall inventory-sales ratio in manufacturing declined slightly in December for the first time in seven months, but remained high in comparison with earlier levels.

The volume of new orders received by durables manufacturers rose $0.9 billion to $23.9 billion in December, following two consecutive months of decline that totaled $2.2 billion. More than half of the December increase reflected the movement of defense orders, as had been the

Chart II
NEW PRIVATE HOUSING STARTS*
Seasonally adjusted annual rate



* Including farm housing starts.
Sources: United States Department of Commerce, Bureau of the Census.

case for the bulk of the earlier decline. Unfilled orders of durables manufacturers remained virtually unchanged in December.

Personal income, which had risen exceptionally rapidly from July to November, grew more slowly in December. Nevertheless, that month's $3.0 billion advance was close to the high average advance recorded in the first half of 1966. Wage and salary disbursements were up by a substantial $2.3 billion, while transfer payments rose by fully $1.0 billion. Dividend receipts, on the other hand, fell sharply—by $1.4 billion—presumably reflecting declines in the profits of some corporations and the need to conserve cash. Consumer credit outstanding increased in December by the smallest monthly amount in almost five years, primarily as a result of a very modest advance in outstanding automobile credit.

Many of the series bearing on the outlook for residential construction have improved somewhat in recent months. Seasonally adjusted residential building contracts, which by October had fallen 43 per cent from their March high, rose by 13 per cent in the following two months. Over the same period, building permits for new private housing units dropped by 44 per cent through October, but then rose 8 per cent by December. Private housing starts between October and December recouped more than one third of their 46 per cent decline from March to October. The upturn in starts, moreover, was broadly based geographically (see Chart II). In assessing these developments, however, it should be recognized that the starts series is highly erratic and that more than two months of data are necessary to establish a trend in any of the statistics mentioned. The housing contraction in 1966 undoubtedly resulted primarily from a shortage of mortgage funds at those institutions specializing in this market. Recently, however, a significantly larger volume of funds has flowed into mortgage lending institutions. In addition, the Federal Home Loan Bank System has made available $1.5 billion of credit to member savings and loan associations for mortgage lending. To encourage member associations to avail themselves of the released funds, the interest rate charged on the bulk of these advances has been reduced to 5¾ per cent. With the basic demand for housing apparently remaining strong, the easing in the mortgage market is likely to lead to a marked improvement in home building. Still, some time will be needed before the rise in housing starts is reflected in actual outlays. Even though the present indications do not suggest an immediate return to the high levels of residential construction prevailing before the 1966 slump, even a modest improvement of housing outlays would remove a major drag on the overall growth of GNP.