The Business Situation

The slower growth of the economy during the early months of 1967 is reflected in the preliminary first-quarter gross national product (GNP) estimates. The rise in aggregate spending for goods and services was one of the smallest in recent years. Moreover, after allowing for the effects of higher prices, there was no change at all in the real volume of national output. The decline in the economy's pace of expansion was primarily the result of a huge cutback in the rate of inventory investment. This reduction in inventory accumulation, from the unsustainably high pace reached in the fourth quarter, went far toward offsetting a very strong overall gain in other demand components. The rise in spending was centered in consumer demand, which showed renewed vigor in the first quarter, and in government demand for goods and services.

The moderation in the overall pace of activity during the quarter resulted in some easing of the pressures on the economy's productive resources. There was a slowdown in the growth of employment and a decline in the rate of manufacturing capacity utilization. The average rate of unemployment in the civilian labor force nevertheless remained at the relatively low 3.7 per cent reached in the fourth quarter. The wholesale price index for industrial commodities held steady in March and apparently in April as well. This recent stability has been due to a further easing of industrial raw materials prices, coupled with a slowdown in the rate of increase in prices of machinery and other finished products. Agricultural prices fell off throughout the first quarter and are estimated to have dropped again in April. As a result, April will apparently see the third consecutive monthly decline in the total wholesale price index. At the consumer level, there have been no actual declines in the total price index but the rate of increase was quite modest during the first quarter. Though consumer food prices have declined in recent months, the reduction has been less steep than that recorded at the wholesale level. Other consumer prices have continued to rise, though at a slower rate than last year, with the index for services continuing to show the sharpest advance.

The most recent data on economic activity suggest that the spring opened on a relatively strong note. However, some of these data are still preliminary and, in any event, indicators for just one month cannot be treated as giving firm evidence of any basic shift in economic conditions. Nevertheless, recent weeks have been marked by a very substantial swing toward greater optimism regarding the prospects for the economy over the months ahead. Personal income growth speeded up in March and retail sales rose sharply, while the unemployment rate edged slightly lower. More broadly, the picture in March was one of stability in a number of other key business indicators whose performance had previously been weak. Industrial production, the factory workweek, and housing starts all edged up slightly, while durable goods shipments and new car sales showed somewhat stronger increases. A positive factor bearing on the economic outlook was the report during April of a survey supporting earlier indications that business capital spending in 1967 will be modestly above last year's high level. In addition, there seems to be a growing consensus that government spending this year is rising more rapidly than had previously been projected, which has made some contribution to a strengthening of sentiment regarding the economic outlook.

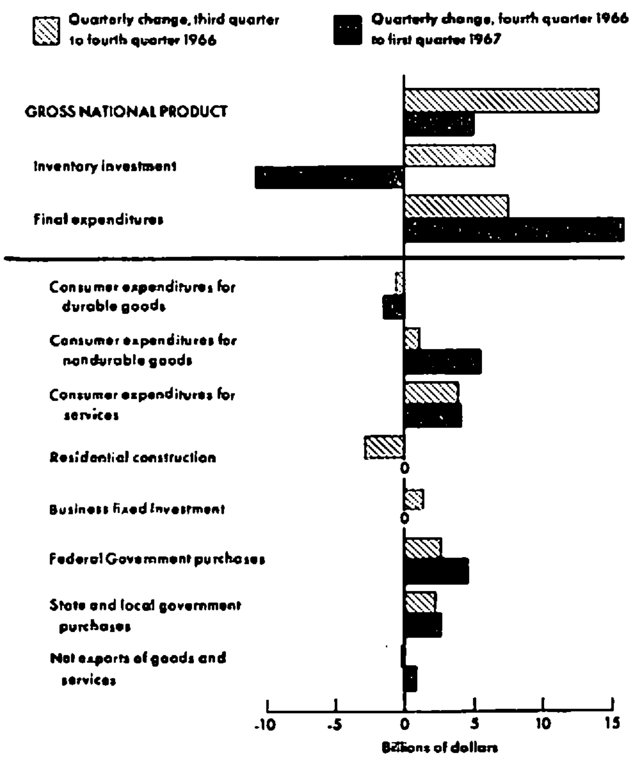
GROSS NATIONAL PRODUCT IN THE FIRST QUARTER

According to the Commerce Department's preliminary estimate, aggregate spending for goods and services increased in the first quarter by $5.0 billion (see Chart I), bringing GNP to a seasonally adjusted annual rate of $764.3 billion. This represented a sharp slowdown in the growth of total output, the first-quarter increase being only a bit more than one third as large as the rise recorded in the final quarter of 1966. The major factor underlying this slowdown was the extremely sharp reduction in the pace of inventory accumulation. During 1966, and particularly in the latter part of the year, inventories had been expanding rapidly, and by the year-end it was evident that stocks were at a very high level relative to sales.

Chart I

RECENT CHANGES IN GROSS NATIONAL PRODUCT AND ITS COMPONENTS

Seasonally adjusted annual rates



Source: United States Department of Commerce.

The cutback in the accumulation rate was therefore not surprising. As in the case of the preliminary first-quarter figures for other GNP components, the estimate of inventory accumulation rests on incomplete data and is subject to revision. On the basis of the available data, the Commerce Department estimates that inventory investment dropped off to an annual rate of $5.5 billion, nearly $11 billion below the excessive pace of the fourth quarter. This was the largest quarterly swing, either up or down, ever recorded in the rate of inventory investment. Business sales performance, however, was generally sluggish in the first quarter, though March brought some signs of improvement. While inventory-sales ratios in manufacturing declined in March, they nevertheless remained considerably higher than they had been as recently as the fourth quarter. Thus, despite the magnitude of the recent cutback in the rate of inventory investment, it is highly probable that there will be some further downward adjustment in the accumulation rate.

The cut in inventory accumulation exerted such a heavy drag on the growth of aggregate demand in the first quarter that it tended to obscure the fact that the overall rise in other GNP components was exceptionally large. Final expenditures—that is, GNP excluding inventory investment—grew by $15.9 billion. This was by historical standards a very strong advance. Indeed, over the course of the past decade only six quarters have witnessed a larger percentage increase in final demand.

Increased spending for goods and services by all levels of government played a prominent role in the growth of demand in this year's first quarter. Federal nondefense purchases rose appreciably, after having moved down somewhat during the course of 1966, and there was an acceleration in the continual growth of spending by state and local governments. Federal outlays for defense purposes—which are four times as large as Federal nondefense purchases—marked up another sizable gain, the rise being about equal to last year's quarterly average. The advance brought the volume of defense spending to $68.8 billion at a seasonally adjusted annual rate, equal to 9.0 per cent of total first-quarter GNP. Two years earlier, in the first quarter of 1965—which was prior to the major expansion of the United States commitment in Vietnam—defense spending was $20 billion lower and equal to 7.3 per cent of GNP.

The first quarter was marked by renewed strength in consumer demand. The rise in total consumption spending was almost twice as large as the relatively weak fourth-quarter increase, even though disposable income grew by the same amount in both quarters. In contrast to the final three months of last year, when there was a sharp jump in the proportion of income saved, consumers were much more prone to spend in the first quarter and there was only a slight further rise in the percentage of income saved. The pickup in consumption spending was centered in demand for nondurable goods. The latest increase in spending on nondurables was the largest in more than a year, and marked a sharp change from the 1966 pattern of progressively smaller quarterly advances. At the same time, demand for services continued to grow strongly. Price advances continued, as in 1966, to account for a large share of the rise in consumption spending on services. By comparison with their impact on outlays for services, price rises have been playing a considerably smaller role in the growth of consumption spending on goods.

Consumer buying of durables dropped off for the second consecutive quarter. The decline in home building over the past year has been one factor behind the sluggishness of durables demand through its dampening effect on purchases of household durables. A major drag has been exerted on durables consumption by the weak performance of automobile sales. In the first quarter, sales of new domestically produced cars averaged a seasonally adjusted annual rate of 7.3 million units, down 10 per cent from the fourth-quarter pace which was, in turn, 4 per cent under the third-quarter figure. After slumping sharply last spring, sales regained some strength during the summer but then fell again through the fall and winter. Recent data, however, suggest that the decline may have been stemmed. The sales rate was only 7.0 million units in February but then increased by about 2½ per cent in March and by a further 5½ per cent in April.

Outlays on residential construction in the first quarter are estimated to have held steady at the fourth-quarter annual rate of $21.9 billion. This stability was in marked contrast to the declines that had cut the spending rate by a total of $6.7 billion over the course of the preceding three quarters. The stability of spending between the fourth and first quarters reflected a monthly pattern that saw spending continue to decline through the last three months of 1966 and then rise in the January-March period. This trend stems from the recovery in housing starts that began late last year. The improvement in starts, which most analysts expect will continue, points to a further strengthening in residential construction spending over the months ahead.

Another GNP component contributing to the rise of aggregate demand in the first quarter was the net export of goods and services, which registered its first increase in almost two years. Typically, a contraction in net exports tends to occur in an economy marked by high and rising levels of production, heavy pressures on productive resources, and rising prices. Over the past two years, imports have consistently grown more rapidly than exports. The resulting shrinkage in net exports has been disappointing in view of the important part played by our trade balance in the effort to move toward equilibrium in the overall balance of payments. The recent rise brought the net export of goods and services to a seasonally adjusted annual rate of $4.9 billion, almost $1 billion above last year's fourth quarter but still well below the 1965 average of $7.0 billion.

BUSINESS INVESTMENT, PRODUCTION, AND EMPLOYMENT

Business fixed investment spending failed to expand in the first quarter after four years of steady quarterly increases. The preliminary estimates indicate that a rise in spending on structures was just offset by a fall in the pace of producers' investment in machinery, vehicles, and other equipment. Following several years of vigorous expansion, the further growth of capital investment outlays in 1966 was a major factor in the excessive demand pressures that characterized the economy through most of last year. The ratio of business fixed investment to total GNP rose somewhat above the advanced level reached in the capital goods boom of the midfifties and, despite the stability of outlays in the first quarter, the ratio has edged off only very slightly.

One factor working to dampen investment spending has been the suspension, as of last fall, of certain tax benefits for investment. The restoration of these benefits is now under consideration by Congress. In addition, an important influence has undoubtedly been exerted by recent trends in corporate profits and capacity utilization. Aggregate profits barely grew in last year's second quarter, then moved down a bit in the second half, and preliminary indications strongly suggest that there was a further drop early this year. At the same time, the utilization rate in manufacturing has eased, as capacity has continued to expand while output first showed a slower growth rate and then, in the first quarter, actually fell off.

A positive note in the outlook for capital investment has been provided by the most recent survey of business spending plans. This survey was conducted by McGraw-Hill in March, at a time when most businessmen had not had an opportunity to rethink their spending plans in the light of the proposed restoration of the investment tax benefits. It found that anticipated outlays for new plant and equipment in 1967 will add up to a 5½ per cent rise over 1966. The latest results thus confirm earlier findings —by McGraw-Hill in January and by the Commerce Department and Securities and Exchange Commission in February—pointing to a further, though relatively modest, advance in capital spending this year. The McGraw-Hill January survey had reported an anticipated 6 per cent advance in spending. A noteworthy aspect of the March results is that, despite the slowing of the economy in the early months of the year, McGraw-Hill did not find evidence of any major downgrading of investment plans. Between January and March, manufacturers of motor vehicles and fabricated metals made sizable cuts in spending plans, but nondurables producers generally revised their plans upward. Among the nonmanufacturing industries, utilities sharply boosted their spending estimates, but substantial reductions were made by the airlines and railroads, which are apparently affected quite severely by the tax benefit suspensions. The slowing of capital spending in the first quarter was reflected in a moderate decline in the output of business equipment in January and February, which was followed, however, by an apparent stabilization in March.

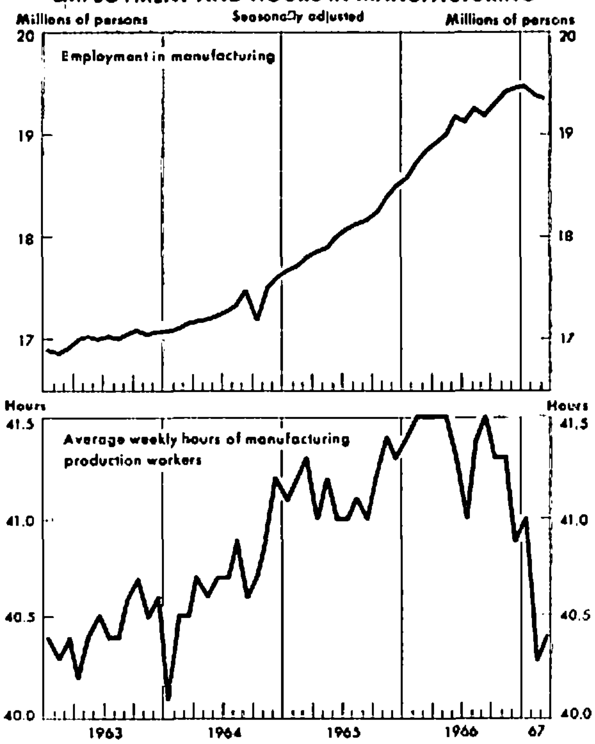
With stability in equipment output and modest gains in other production sectors, the Federal Reserve Board's seasonally adjusted index of industrial output rose a bit in March after two months of decline. Production of defense equipment showed another significant increase, while output of materials was about unchanged. Consumer goods production rose after a sizable drop in the first two months of the year, with the March advance primarily attributable to a recovery in automobile output. The March increase in auto assemblies, though strong, followed steep declines in the first two months of the year. Thus, despite the month's improvement, March output was at a seasonally adjusted annual rate of only about 6.9 million units, almost 20 per cent below the December rate. April apparently saw a further substantial rise in the auto assembly rate, even though trucking strikes during the month caused manufacturers to fall a bit behind their production schedules.

The volume of new orders for durable goods decreased a bit in March after having risen in February. The sharpest drop, more than accounting for the month's overall decline, was in orders received by steel producers. The defense-related industries, whose orders tend to fluctuate rather widely from month to month, also experienced a decline in March but increases were reported by producers of machinery and equipment. Durables shipments rose in March, on the basis of a substantial increase for the aircraft industry and modest gains for most other durables groups. With shipments once again exceeding the flow of new orders, the backlog of unfilled durables orders declined further. Over the first three months of this year, the total durables backlog shrank by about 3 per cent. In most major industries the declines were fairly moderate, but steel producers experienced a drop of nearly 25 per cent—which accounted for fully one third of the total shrinkage in the durables backlog. The slackening in the steel industry in the first quarter was attributable to the easing of demands in a number of sectors, especially in the automobile industry and in industries producing other consumer durable goods.

Developments in the labor markets have reflected the easing of demand pressures in the economy, but the employment picture has remained quite strong on balance. In the manufacturing sector, employers have recently cut back moderately on the number of production workers on their payrolls, while at the same time slowing the rate at which they add nonproduction workers. As a result, total manufacturing employment dropped off during the first quarter (see Chart II). A much larger downward adjustment has been made in the average number of hours put in weekly by production workers. Thus, the bulk of the reduction in the number of man-hours worked in manufacturing, in response to an easing of demands, has occurred through a shortening of the workweek rather than through a cut in the number of employees.

In nonagricultural industries outside manufacturing, the employment picture was mixed in March. The number of workers on payrolls in government and the service industries continued to rise strongly, while declines were registered in trade and construction. In terms of the total civilian labor force, however, the continuation of relatively strong employment conditions in March was indicated by the slight drop in the unemployment rate, to 3.6 per cent from 3.7 per cent in the preceding three months.

Chart II
EMPLOYMENT AND HOURS IN MANUFACTURING



Source: United States Bureau of Labor Statistics.