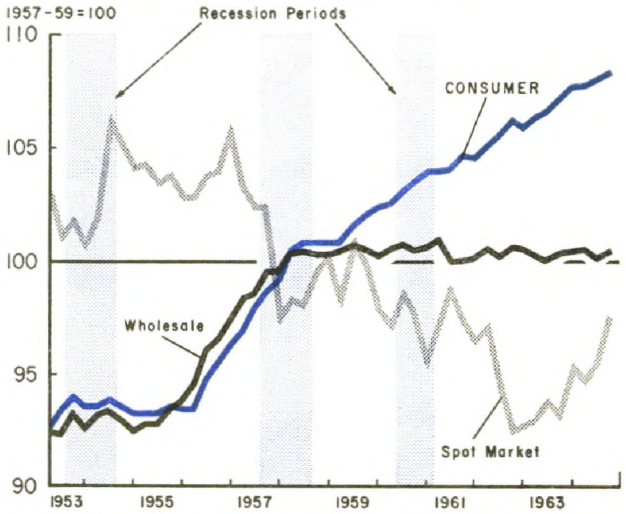
Hard-Driving Finish

ECONOMICS has been largely overshadowed by politics in recent months, but business analysts now are able to concentrate again on the state of the economy rather than the state of the nation. Specifically, they can now investigate the question that crops up at this advanced stage of every business expansion—too fast or too slow? So far, there are two conflicting answers. While anticipating that the economy will add a hard-driving finish to a very prosperous year, some observers worry about an over-rapid pace of advance and, indeed, discern shortages of men, materials, or machinery developing in 1965. (Among other pieces of evidence, they point to a 15-percent rise since the turn of the year in spot prices of industrial materials.) Other observers, however, question whether the recent rate of expansion can be sustained far into 1965, especially in view of the recent downturns in housing and defense spending and the waning stimulus from 1964's massive tax cut.

Third-quarter statistics provide the backdrop for these conflicting speculations. In that period, GNP increased about $10 billion to a $628.4-billion annual rate (seasonally adjusted). The gain in total output was just about the same as the gain recorded in each of the four preceding quarters. But when account is taken of the (perhaps involuntary) slow-down in the rate of inventory accumulation, a different picture emerges. In fact, the quarterly gain in final sales (GNP minus inventory change) shows up as one of the strongest in the expansion to date.

Consumption spending dominated the third-quarter situation, as consumers saved somewhat less and spent considerably more than in the immediate aftermath of the tax cut. The advance in business plant-equipment spending also continued unabated during the quarter. Government expenditures in the aggregate

Upsurge in spot market prices
gives rise to inflationary fears



Sources: Department of Labor; Department of Commerce.

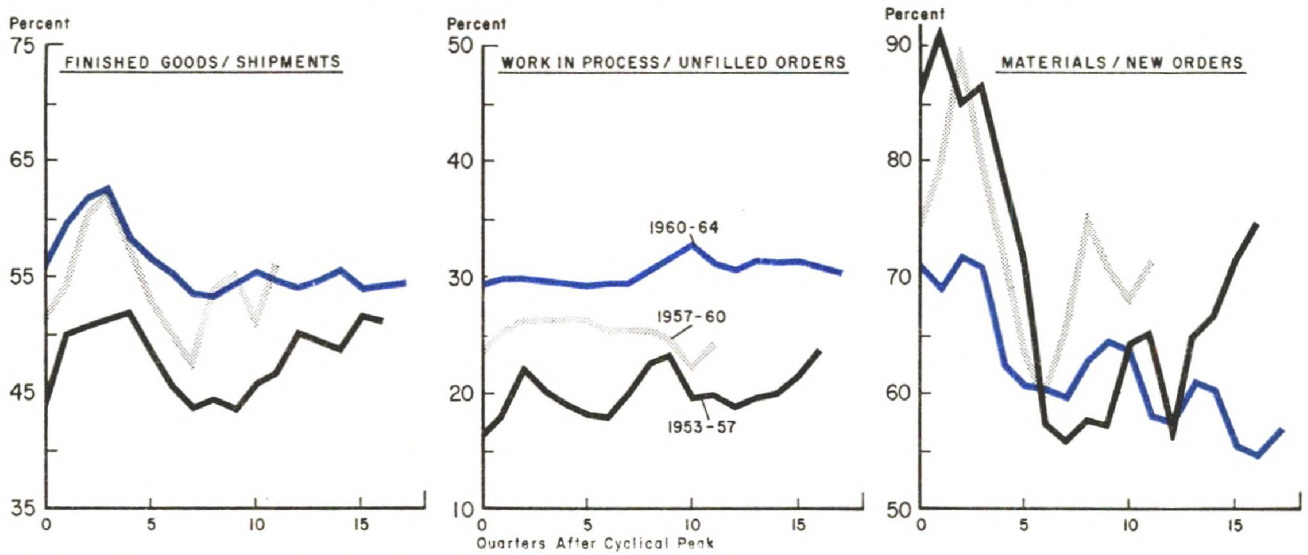
remained relatively stable, although defense spending fell off from the unusually high second-quarter level. Meanwhile, residential construction continued to decline from the record high attained early this year.

Pressures on prices

Looking towards 1965, inflation-minded critics discern several worrisome signs—for example, on the labor front. A major steel producer tried to recruit 1,000 workers for its Chicago operations in the hitherto-depressed Pennsylvania mill towns, and obtained less than half of the number required. (And still, the national unemployment rate remains above 5 percent.) In addition, the auto industry negotiated a greater-than-guidelines wage settlement, and the cost implications of that event prompted Treasury Undersecretary Roosa to question whether such settlements might not constitute a "fundamental risk" to a further improvement in the nation's balance of payments.

Some signs of strain have also developed on the machinery and materials front. Durable-goods manufacturers are now trying to work down an order-book that has expanded by 10

Hard-goods firms show decline in ratio of materials stocks to new orders, but maintain stable inventory ratios at final and intermediate stages of production



Sources: Department of Commerce; Federal Reserve Bank of San Francisco.

percent since the beginning of the year. Until recently, order backlogs of steel producers grew quite rapidly. Not surprisingly, then, these producers maintained full-schedule operations throughout October, even in the face of a month-long strike over local-union issues at the auto firm which normally takes one-tenth of the nation's total steel output.

In view of all the pressures, incipient or actual, business pundits are focussing their attention increasingly on the price situation. The consumer and wholesale indexes have furnished no clues; consumer prices are edging upward, as they have throughout practically all of the past decade, while the wholesale index is now completing its seventh straight year of crabwise movement. But the commodity spot-price index furnishes strong evidence of accumulating pressures. As already noted, prices of industrial raw materials have risen about 15 percent since the turn of the year—and most of the gain has taken place just within the past several months.

Whether bottlenecks actually develop, however, will greatly depend on the strength of demand. Business plant-equipment spending for the present looks strong; anticipated spending for the current quarter is about 12 percent above the year-ago level, and it may turn out even higher, since actual expenditures have exceeded anticipated expenditures consistently this year. Government spending may rise only slowly, especially in view of Secretary McNamara's announcement that defense outlays will be more than $1 billion below the preceding year's total in fiscal 1965. But consumers meanwhile will be dealing with the substantial increase in take-home pay—an 8-percent increase over the past year—that has been generated jointly by the tax cut, favorable wage settlements, and a broadly based business expansion.

Consumer buying plans thus will help determine whether 1964's hard-driving finish generates enough momentum for a strong 1965. Consumer incomes are probably high enough to support a fourth-straight phenomenal auto year or to cushion the current decline in housing; the major question is how the consumer will allocate his recently expanded budget. But this, of course, is only one of the factors determining the size and shape of the 1965 economy.

Depleted stockroom?

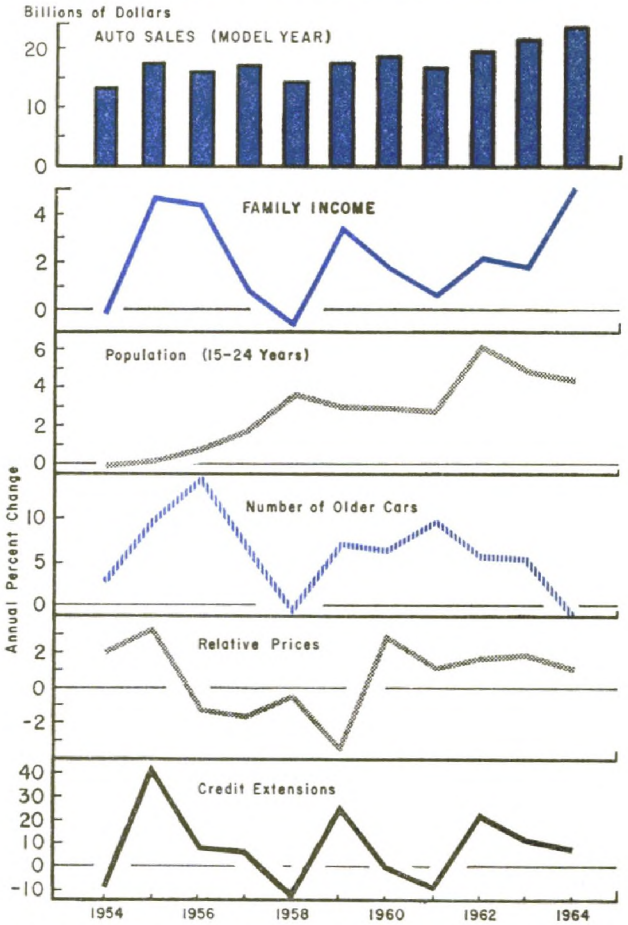
Another question concerns the strength and the direction of inventory spending. The increase in stocks was relatively low last quarter, as it has been in most periods since early 1962, but the latest Commerce Department survey of inventory expectations suggests that further increases are in store. Manufacturers have projected a moderate expansion in inventory spending for this quarter; more important, at the beginning of the last quarter only 13 percent of the group considered their inventories to be too high, whereas 29 percent thought so at the peak of the last expansion in 1960.

A more objective picture of the inventory situation can be gained by comparing the status of manufacturers' stocks with the status of their orders and shipments. In the durable-goods sector, for instance, the ratio of finished-goods inventories to shipments has fluctuated somewhat less in recent years than in the two preceding business cycles. The same relative stability has been evidenced by the ratio of work-in-process inventories to unfilled orders. In addition, the ratio of materials inventories to new orders has dropped substantially during this expansion, to levels considerably below those recorded at corresponding points of previous cycles. These developments suggest that businessmen have been surprised by the rapid pace of the expansion and have involuntarily reduced their stocks, at least at the initial stage of the production process. But they also support the conclusion that purchasing agents and their trusty computers have been successful in maintaining an optimum stockroom balance and in holding the materials inflow at the minimum possible level necessary for efficiency.

Fourth record year?

A major question in the outlook concerns the ability of the auto industry to put together its fourth "back-to-back" record year. Consumers purchased $20 billion worth of auto and parts in the 1962 model year and followed that up with a $22-billion total in 1963—and then they raised their spending to about $24 billion in the model year just ended. The industry attempted to keep the string going into 1965 by offering prospective buyers a choice of 343 models at relatively stable prices, and it tried to achieve a strong start on the production end by negotiating a substantial settlement in its labor contract renewal. But then a major part of the industry bogged down in a prolonged dispute over local-union work standards.

Strong gain in consumer income supports another record auto year



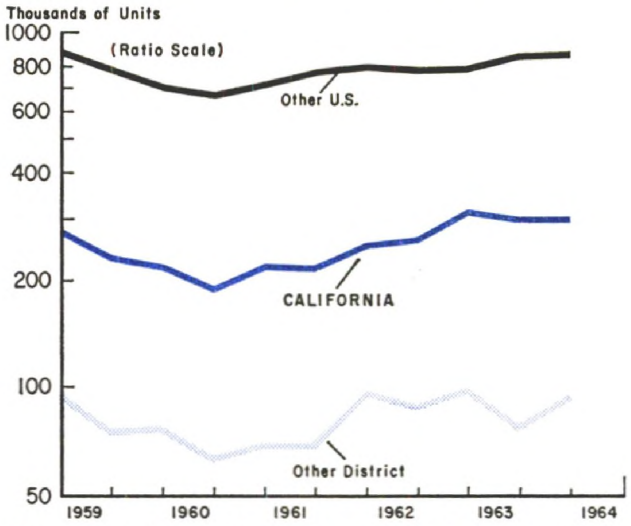
Note: Bar chart shows dollar sales of autos and parts in each model year (beginning one quarter before calendar year). Line chart shows annual percentage change in factors affecting auto sales—family income in 1963 dollars, population aged 15-24, number of cars 5 years or older (at beginning of model year), difference between changes in consumer price index and new-car price index, and amount of auto credit extended.
Sources: Department of Commerce, *Automotive News*, Department of Labor, Board of Governors of the Federal Reserve System.

Steel mills and parts supliers, which continued to run at full tilt while the production lines of their largest customer remained motionless, soon found their inventory facilities under strain. Some managed to shift their production to other accounts, but others by late October were contemplating production cutbacks and layoffs to ease the situation. Then again, the auto market was complicated by the loss of perhaps 500,000 scheduled units by the end of October. This development put a heavy strain on consumer brand loyalties; in fact, it opened the possibility of permanently lost sales, since many consumers who were disappointed by empty showrooms at model-introduction time may now sit out the rest of the year as well.

Nonetheless, the industry's market researchers could still point confidently to the strength of the factors underlying consumer demand. The record 1964 model year, like its several predecessors, was based on such factors as the easy availability of auto credit, the relatively slow growth of auto prices, the large number of old cars headed for the scrapheap, and the increasingly large number of young drivers headed for auto showrooms. But probably the strongest determinant of the high '64 sales rate was the substantial gain during the year in average consumer income—a gain from which the industry expects to benefit in 1965 also.

The outlook is somewhat more questionable in residential construction, the other major consumer "investment" sector. Despite the high level of consumer income and the easy availability of mortgage money, spending for new housing fell about 5 percent between the first and the third quarters of this year, while housing starts dropped off steeply from the peak attained a year ago. In this situation, housing analysts tend to believe that the industry has temporarily outrun its market—more specifically, that there may be a dearth of newlyweds and retired individuals capable of renting the higher-priced apartment units that the industry has constructed with such abandon in the last several years.

Housing activity weakens in West, in contrast to situation elsewhere



Note: Chart shows semi-annual average of housing starts, at annual rate, but without seasonal adjustment.
Source: Department of Commerce.

Strengths and weaknesses

On the national scene, then, the amount of forward momentum carried into 1965 may well depend on such things as consumer spending plans for cars and housing and on businessmen's inventory response to changing consumer plans. On the regional scene, the situation will be influenced by these factors but also by developments in the crucial (and now somewhat uncertain) defense spending sector.

Consumer spending in Twelfth District states has been quite strong throughout most of the year. For instance, retail store sales during the first nine months of the year were 8 percent above the year-ago level, as compared with a 6-percent increase for the rest of the nation. During the same period, new car registrations in the District were 14 percent above the year-ago figure, as compared with a 10-percent gain elsewhere.

On the other hand, that better-than-national performance was lacking in the housing field.

In fact, the widely discussed housing downturn could be described substantially as a Western phenomenon. Housing starts in the 13-state West fell about 10 percent below the year-ago level during the first nine months of this year, whereas starts increased 4 percent elsewhere in the nation (cumulated basis). The problem could be further described in terms of the apartment-housing situation, especially in view of the continuance of the wide spread between Western and national rental vacancy rates. The rates averaged about 9.7 and 7.3 percent, respectively, in the first half of this year.

Much of the strength in consumer spending undoubtedly has developed because of the continuing expansion of aggregate employment throughout the year — and probably much of the downturn in residential construction could be traced indirectly to the continuing downturn in defense-related employment. Total employment in the District averaged 9.65 million during the third quarter (seasonally adjusted) for an 0.4-percent quarterly gain and a 2.3-percent gain over the past year. Moreover, the District—unlike the rest of the nation—recorded a quarterly increase in nonfarm employment, despite a job decline in durable-goods manufacturing.

How much for defense?

About 47,000 workers were laid off by District defense manufacturers during the first three quarters of 1964, for a total of 74,000 layoffs since the December-1962 peak. Yet, even though the labor force in the District exceeds 10 million, those relatively few layoffs possess considerable significance. If, for example, the 74,000 jobs lost since the peak had been transferred from the unemployment to the employment column, the District unemployment rate would have dropped by this September to the national rate of 5.3 percent instead of rising to 6.0 percent as it actually did.

Admittedly, the layoffs have tapered off as the year has progressed. Defense employment in District states declined by 21,000 in the first quarter, 16,000 in the second quarter, and 9,000 in the third quarter—and defense jobs thus totalled 585,000 in September. The third-quarter reduction was confined largely to California firms, primarily in the Los Angeles and San Diego areas.

Nonetheless, the defense picture remains mixed. Recent layoffs have occurred in the face of a relatively stable inflow of new business to District firms, including one $500 million follow-on contract to a California firm for the Apollo moon-shot program. Moreover, the order backlog nationally for military and commercial aircraft has actually increased in the last several months. But Defense Secretary McNamara recently announced that total spending by his agency in fiscal 1965 will be more than $1 billion below the total spent in the 1964 fiscal year — and District firms normally account for almost one-third of all Pentagon contract awards.

From farm to forge

Mixed performances were also recorded recently by other major District industries. In the third quarter, lumber felt the repercussions of the slowdown in housing activity. Lumber ordertaking remained in the doldrums, while prices gradually drifted downward to levels below those prevailing during the post-strike period a year ago. In October, however, a rise in orders cushioned the price downturn.

Steel output in the District rose during October to a level 22 percent above the year-ago figure, although somewhat below the 1964 high registered in May. National production meanwhile reached a level 36 percent above the year-ago figure. The difference developed in large part because producers outside the District are the major beneficiaries of the inventory hedge-buying program now being undertaken by auto manufacturers.

District petroleum refineries increased their processing activity during the third quarter, and they also increased their imports because of lagging production of domestic crude oil. (Foreign crude accounted for more than one-third of District crude supplies during the quarter.) But despite the expansion in demand for refined products, prices (especially gasoline prices) weakened during the period. In the California market, where gasoline sales exceed 18 million gallons daily, prices per gallon were down as much as 7 cents below normal.

In the farm sector, prices were generally depressed during the third quarter, but receipts were maintained at year-ago levels because of heavy marketings. Crop production prospects generally improved during the period, so that the Western harvest may well reach record proportions. Incidentally, the role of Mexican workers in this performance has been just as great as in earlier years; at the seasonal peak, bracero employment reached 69,000, or about the same as in 1963.

Beef-cattle sales during the third quarter were particularly heavy—about 16 percent more than in the year-ago period. Low beef prices meanwhile discouraged the importation of foreign beef; inspections, in fact, ran about one-third below the year-ago level during the third quarter.

With only several exceptions, then, Western producers and consumers have been performing just as admirably as their counterparts elsewhere in the nation. Gains in employment, income, and consumer spending have been especially noteworthy. The record to date thus suggests that a strongly expanding year will end with a hard-driving finish, and that the expansion will carry into the new year and thereby ease the task of 1965 in solving the problems posed by the defense and housing sectors during 1964.

Rise in Discount Rate

On November 23, the Board of Governors of the Federal Reserve System approved actions by the directors of five Federal Reserve Banks (Boston, New York, Philadelphia, Chicago, and St. Louis) increasing the discount rates of those banks from 3½ to 4 percent. The Board of Governors also increased the maximum rates that member banks are permitted to pay on savings deposits and time deposits. The System's actions, which were taken "to maintain the international strength of the dollar," followed in the wake of the rise in the British Bank rate from 5 to 7 percent. The Federal Reserve Bank of San Francisco moved to the 4-percent rate on November 25.

The permissible maximum rate on savings deposits was set at 4 percent; previously, the 4-percent maximum was permissible only for deposits of one year or more. The permissible maximum rates on time deposits and certificates of deposit were set at 4 percent for maturities of less than 90 days and 4½ percent for all longer maturities; for those same maturities, the maximum rates previously permissible were 1 percent and 4 percent, respectively.

These Federal Reserve actions were designed, first, to counter possible capital outflows that might be prompted by any widening spread between interest rates in this country and higher rates abroad, and, second, to ensure that the flow of savings through commercial banks remains ample for the financing of domestic investment.