monthly review

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FEDERAL RESERVE BANK OF KANSAS CITY

Agricultural Outlook: Approach of the 1970's

By Gene L. Swackhamer

ECONOMIC forecasting is not an exact science, but it is a necessary and valuable part of public policy formulation and business management. This article will focus attention on current developments and longer-run trends in the agricultural sector with primary emphasis on identifying the factors influencing agriculture. In focusing on economic relationships, it is appropriate to look beyond 1969 and current issues because of the transitive status of agricultural policy and the dynamics of the agricultural sector. Just as the past two decades have shown how elusive solutions can be to excessive productive capacity in agriculture and persistently low per capita incomes of farmers, agricultural problems of the 1970's undoubtedly will prove to be just as difficult because of the continuing technological transformation.

The adjustment problem in agriculture is an integral part of industrialization and economic development. As wealth increases, the demand for nonagricultural products grows faster than for agricultural goods. Consumer purchases under our market system are the influences that direct production and bring about resource adjustment. However, the adjustment process is seldom easy. Resource mobility involves social considerations and a lack of flexibility frequently results.

It has been estimated that out of a 10 per cent increase in per capita income, probably no more than 2 per cent is spent for farm products in the current stage of economic growth in the United States. As incomes rise, the share spent for food and farm products tends to fall, even though food prices are rising. Thus, to maintain balance in a growing economy, resources must shift to those sectors where demand is increasing. When resource adjustment is slow, prices rise in the sectors of growing demand where supplies are short and fall in the sectors of surplus production.

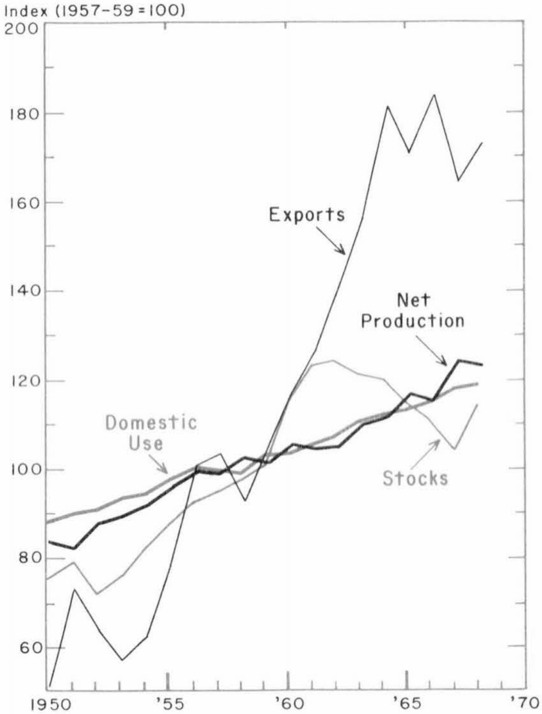
Agricultural adjustment has taken place at a remarkable rate; yet, the influence of new technology on production has more than offset land diversion and labor outmigration. The productive capability of agriculture has led to record output (Chart 1), but demand for agricultural products has continued to increase at a very stable rate of only about 2 per cent yearly, compared with much higher annual rates of production increase per unit of input. The result, of course, has been underemployed resources, chronic surpluses, and low per capita farm incomes—the farm problem.

POLICY ISSUES

A rational farm policy should facilitate agriculture's adjustment to the future without undue burden on farmers. Likewise, there is a role for both free markets and government in a rational farm policy. Free markets can solve

Chart 1

SUPPLY AND UTILIZATION OF FARM FOOD COMMODITIES



SOURCE: U. S. Department of Agriculture.

the supply-demand balance problem, but they also introduce undesirable price fluctuations and instability. Furthermore, agriculture should not be expected to operate with free markets in an economic environment that is characterized by inflexibility and administered prices. The role of government is to minimize economic instability and maintain real growth in the economy. Government must be careful not to introduce instability through incorrect action.

Several philosophies have guided agricultural policy since World War II. In the 1950's, the Soil Bank and Public Law 480 came into existence. The goal of the Soil Bank program was to remove land from production to achieve a better supply-demand balance. This was a more acceptable alternative than an abrupt return to free markets. The voluntary Soil Bank program did remove land from production, but did not prevent further surplus accumulation as the remaining acreage was farmed more intensively. Public Law 480 has been more successful in disposing of excess agricultural production by providing food aid to developing nations and developing hard currency markets for our products.

Early in the 1960's, supply management was advocated—which was unacceptable and was soundly defeated in a wheat referendum. Finally, a farm policy evolved that provided for: (1) price supports at near world levels to encourage supply-demand balance, (2) continued acreage diversion to hold back production, and (3) direct payments to improve farm incomes.

Surpluses generally have been worked down, but the reasons for this success are a composite of several factors: stronger economic activity, growth of foreign demand, less price incentive for excess production, and acreage diversion. Farm incomes have improved in both the aggregate and on a per farm basis as a result of stronger markets, diversion and direct payments, and continued resource adjustment.

Farm policy in the 1970's will face some major obstacles—both new and old. Policymakers will be challenged to justify the high cost of Government farm programs. The rising cost of current programs for diverting land from production temporarily will likely undergo review. Nearly 50 million acres of cropland are currently idled, and because of rising productivity an additional 10 million acres of diversion may soon be needed. The need for a long-term solution is obvious and will receive more attention.

Although there is considerable sympathy for programs of income adjustment through transfer or direct payments to compensate farmers with low incomes, many farmers dislike these programs—and the programs would further delay resource adjustment unless instituted on a temporary or transitional basis. High price supports—because of their tendency to result in surplus production and their inability to materially aid low income farmers on small farms—are not universally appealing either. Farm policy in the 1970's may continue to move closer to free markets with price supports held near world market levels or rescinded, and direct payment programs used to soften the burden of economic adjustment. However, restrictions on technology are quite unlikely since they are counter to efficiency and progress.

Extension of the 1965 Agricultural Act for an additional year—now to expire at the end of 1970—solved some of the uncertainty behind this year's agricultural outlook, but it also focuses attention on the short-run application of many present farm programs. The reluctance of Congress to extend farm legislation for more than one year—and the nearly successful attempt to limit payments to any one individual—signals a likely rethinking of farm policy issues. In the meantime, several farm programs are set for this year.

A national wheat allotment of 51.6 million acres—down 13 per cent from that planted for harvest in 1968—has been announced. A crop of about 1.3 billion bushels is desired to meet current needs and reduce carryover somewhat. The voluntary program again relies upon a combination of price-support loans, marketing certificates, and diversion payments to obtain farmer participation.

This year's feed grain program will seek a diversion of nearly 5 million more acres than in 1968 with a minimum diversion of at least 20 per cent of each farm's feed grain crop base required for participation as in prior years. To encourage farmer participation, price support loan and payments levels will be continued, with provisions made to encourage additional voluntary acreage diversion beyond the required minimum.

Because of rapidly increasing soybean inventories—as production has been expanded more rapidly than total utilization—producers are being encouraged to curtail production expansion. The price-support loan level may be lowered from $2.50 per bushel for this year's crop. Restrictions on substituting soybeans for other grain crops could dampen continued surplus production.

LIVESTOCK SECTOR REMAINS DYNAMIC

Livestock marketings account for about 55 per cent of total cash receipts from farm marketings in the United States. However, in the Tenth Federal Reserve District (Colorado, Kansas, Nebraska, Wyoming, most of Oklahoma and New Mexico, and part of Missouri) livestock marketings comprise approximately 65 per cent of total cash receipts to farmers. In view of this heavy dependence on animal agriculture and the relative importance of meat animals in this category, farmers and ranchers have benefited substantially in recent years from a strong and growing consumer demand for red meat. With the exception of 1964—a year of depressed livestock prices—cash receipts from livestock have risen from 2 to 3 per cent in most years; with outstanding increases of over 10 per cent recorded in 1965 and 1966. Although final figures for 1968 are not yet available, livestock marketings will likely show cash receipts about 1 per cent above year-ago levels nationally and nearly 3 per cent above year ago for the Tenth District.

A question of major importance in 1969 is whether consumer demand for red meat will be strong enough to absorb larger beef and pork production without substantial price weakness. Aside from population growth, which contributes a stable increase to yearly demand, consumer incomes and the level of economic activity are important demand considerations. Increased livestock production and higher marketing margins in recent years could have led to depressed farm prices but, because of high levels of employment and rising incomes, per capita red meat consumption has risen. Of the

17 per cent of consumer disposable income spent for food annually, a large part goes for meat. The willingness of consumers to increase per capita consumption of red meat during the past few years has averted a serious oversupply problem.

The outlook for this year is not as promising. The rate of expansion in economic activity and consumer incomes is likely to slow. The increased rate of Social Security tax withholding and higher income taxes will have an adverse impact on disposable income growth at least early in the year, and the willingness of consumers to maintain a high level of consumption will be tested. With continued abundant supplies of red meat and poultry, downward pressure on farm prices would not be surprising. Farmers must strive for orderly marketing of livestock yielding the type of meat products consumers prefer. With an abundant supply of feed grains and larger numbers of livestock on feed, the outlook is for aggregate output of livestock products in the first half of 1969 to be above 1968 levels, but only modestly exceeding 1968 output for the entire year.

Cattle

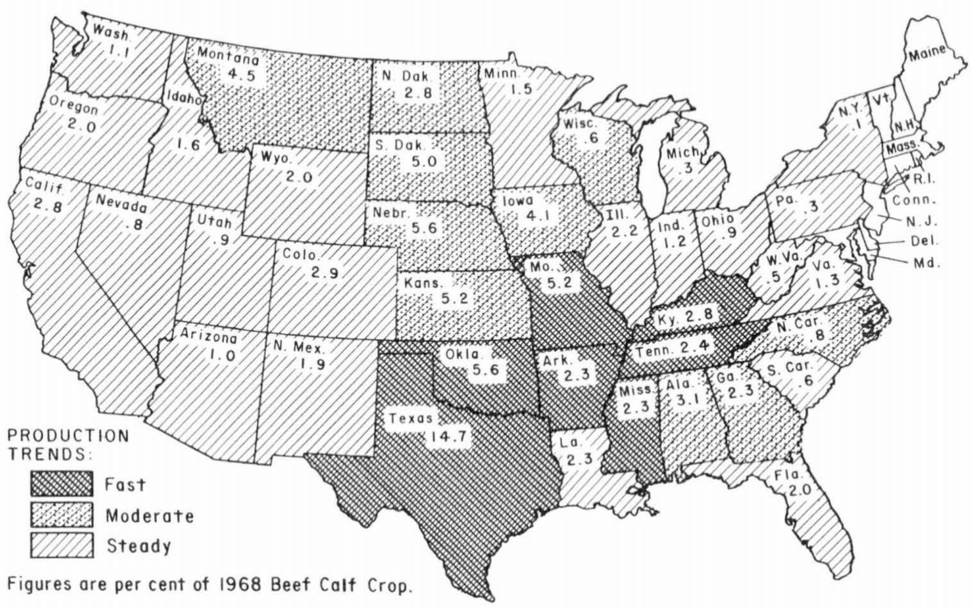
A major realignment in regional production and feeding of cattle is taking place and will become more evident in the 1970's. The trend in calf production (Chart 2) is defined as the change in state calf crops from 1948 to 1968 weighted by each state's relative share of the total number of calves, combining both rate of growth and share of total to identify areas of fast, moderate, and steady production. The area of fastest development extends from the Southwest into the Mississippi valley.

Cattle feeding also has continued to shift into the Southern Plains and Southwest. Favorable climatic conditions, an abundance of feed

Chart 2

BEEF CALF PRODUCTION TREND

1948-68

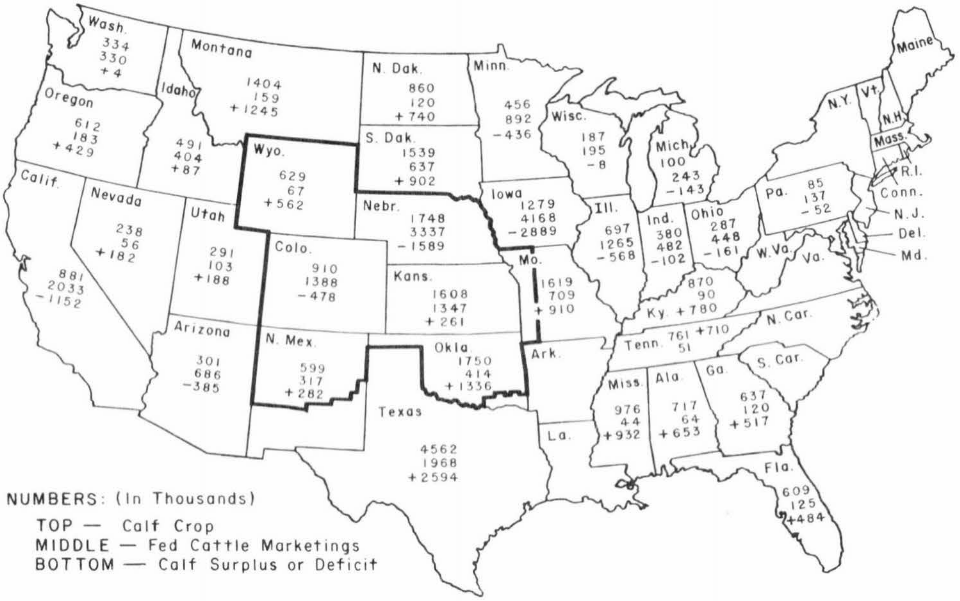


SOURCE: Derived from Western Livestock Marketing Information Project data.

Chart 3

BEEF CALF CROP AND FED CATTLE MARKETINGS

1968



SOURCE: Derived from Western Livestock Marketing Information Project data.

grains, growth of population and population shifts, and the supply of feeder cattle have all been significant factors influencing feeding. Fed cattle marketings, the beef calf crop, and the net deficit or surplus for 1968 are shown by states in Chart 3. Tenth District states accounted for 34 per cent of the fed cattle marketed and 29 per cent of the beef calf crop in 1968.

Further expansion of cattle feeding in 1969 is expected. The October 1, 1968, *Cattle on Feed* report indicated that over 9.5 million head of cattle were on feed, 11 per cent above the year before and nearly 25 per cent more than the comparable quarter of 1965. Because of the rapid expansion in cattle feeding, the increased feeding of heifers, and the movement of more calves to feedlots, some concern has been expressed that inventory reductions are likely. However, existing data indicate that a larger calf crop, live cattle imports, and improved husbandry of cow herds will about offset increased slaughter—leaving the 1969 inventory about the same as last year. Furthermore, a larger proportion of all cattle slaughtered in recent years has been fed cattle. Thus, less nonfed domestic beef is being produced.

Fed cattle prices are likely to weaken as winter advances because of large supplies of beef, competition from increased pork and broiler volume, and a smaller gain in demand. Although some seasonal price improvement seems likely, average fed cattle prices in 1969 may be little changed from the past year if yearling and calf placements continue large.

Hogs

Further expansion of pork production in 1969 seems likely. A favorable hog:corn ratio (the bushels of corn equal in value to 100 pounds of live hog) since mid-1967 has led to increased farrowings. A report on farmers' intentions indicates that the spring pig crop may exceed last year's by 5 per cent. Much hinges on hog and feed grain prices this winter, but expansion well into 1969 seems imminent.

The pressure of increased supplies of pork, moderate growth in demand, and competition from other meats is likely to hold summer hog prices below comparable year-earlier levels through most of 1969. Profit prospects for hog producers in the coming year appear to be less favorable than during the past year, and some production cutback may be evident by late 1969.

Sheep and Lambs

Commercial sheep and lamb slaughter in 1968 was nearly 7 per cent below a year earlier. This decline primarily reflects a smaller lamb crop of only 14.5 million head—a decline of 4 per cent—but may also signal a slowdown in further inventory reduction. Although ewe lambs appear to have been held for breeding ewe replacement, the January 1, 1969, inventory of sheep and lambs will again be lower, with numbers declining below 14 million head.

Lamb prices continue to show strength because of reduced lamb production and likely will continue to hold above year-ago levels throughout the winter.

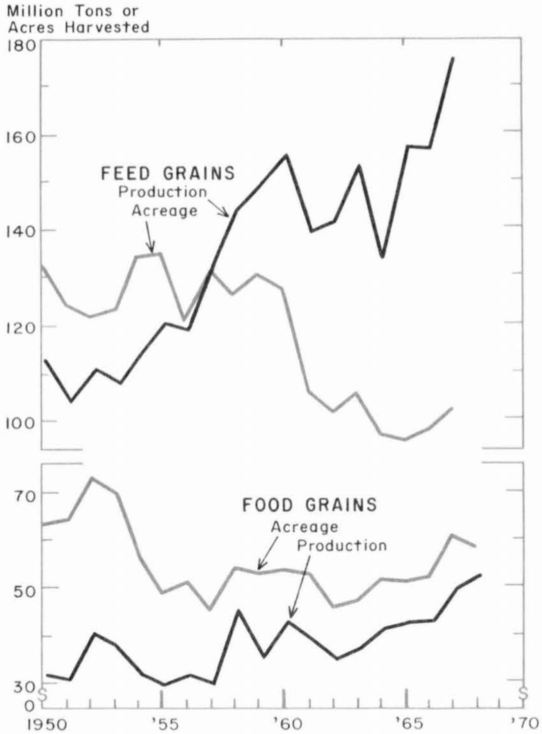
FOOD AND FEED GRAINS

The supply of food and feed grains continues to rise to new record levels, but so does consumption. Feed grain production (corn, sorghum grain, oats, and barley) in 1968 was about 168 million tons and food grain production (wheat and rice) rose to 54 million tons. An important factor behind these records is new production technology—including improved hybrids, and widespread use of fertilizer and chemicals which result in improved yields.

Chart 4

FOOD AND FEED GRAINS

Crop Acres and Production
1950-68



SOURCE: U. S. Department of Agriculture.

Demand has increased because of population growth, expanding economic activity, broader foreign trade, and expanded livestock feeding.

The relationship of production to acres harvested is illustrated in Chart 4. Food grain production has shown steady expansion since 1962 primarily because of increased acreage, but also due to modest yield improvement. Feed grains have shown dramatic production expansion since the early 1950's on a declining number of acres. Although future production will be influenced by the kinds of farm programs that prevail after 1969, the trends are clearly established. Sufficient technical know-how exists to meet food and feed grain needs on about 160 million acres. Programs that encourage plantings beyond this level probably would contribute to increasing carryovers unless demand can be expanded substantially more rapidly than during recent years.

Food grain production rose to a record level in 1968, as record wheat and rice yields and production were realized. The average U. S. yield for wheat exceeded 28 bushels per acre. Rice production averaged 4,475 pounds per acre. The likelihood that continued high production can be achieved with fewer acres seems good, though the rapid divergence of acreage and production—as in feed grain production—is not expected in the next few years.

Total disappearance of feed grains during the 1968-69 marketing year is expected to about equal 1968 production, leaving a carryover of about 50 million tons. Favorable livestock-grain price relationships are expected to stimulate livestock feeding, while exports are expected to remain near 1968 levels. Feed grain prices have weakened substantially from their 1966 highs because of expanded production. Although Government support programs have added substantially to feed grain stocks (under loan and Commodity Credit Corporation stocks) during the past two years, "free" supplies remain large and prices have been hard-pressed to hold above support levels.

Corn

A smaller corn crop in 1968 than the year before, but a larger carryover of old corn, has pushed total supply to nearly 5.6 billion bushels (Table 1). Corn prices during 1969 will depend on how much the pressure of excess supply can be reduced through loan and reseal programs, higher feeding rates, and export expansions. Because of low prices and seasonal price weakness at harvest, there is considerable incentive to place corn under loan and to reseal old-crop corn. Favorable livestock:feed price ratios indicate further expansion of domestic use in 1969, and a somewhat smaller supply of foreign-produced corn coupled with relatively low U. S. prices should encourage a favorable export situation. Under the best of conditions, utilization of corn in the 1968-69 marketing year could equal 1968 production with no net addition to carryover by next October.

Wheat

Another year of favorable weather, along with improved varieties and cultivation practices, produced a record wheat crop on 5 per cent fewer acres than in 1967. The average yield per acre rose to 28.4 bushels. The impact of record production and the second consecutive year of stock increases have produced at least two significant developments. First, ample supply and low wheat prices have encouraged heavier feed use. The use of wheat as feed in the 1968-69 marketing year will probably double the 64-million-bushel rate of 1967-68. Second, 1969 crop allotments have been reduced to 51.6 million acres from 59.3 in 1968, which was itself a reduction from 68.2 million acres in 1967. Under normal weather conditions, a crop of 1.3 billion bushels is anticipated, but carryover stocks will increase for the third straight year to about 765 million bushels by July 1, 1969. Three big "ifs" control the price picture this year. If exports reach the 750-million-bushel target, if extensive amounts of wheat are placed under loan, and if 1969 crop prospects show the anticipated reduction, then some seasonal strengthening of wheat prices can be expected—but the prospects are for little deviation from the national loan rate of $1.25 per bushel.

Sorghum Grain

The supply of sorghum grain is estimated in excess of 1 billion bushels for the 1968-69 marketing year. Because of favorable cattle: feed price ratios and continued heavy feeding of cattle in the Southwest, the domestic demand for sorghum grain is expected to reach 580 million bushels. Competition for export markets continues to increase—holding export prospects in 1969 below the 200-million-bushel level achieved in past years. The outlook is for total utilization to about equal 1968 production (Table 1). As evidenced by the report of the National Advisory Committee on Grains, some cutback in 1969 sorghum grain acreage is likely.

Oilseeds

Although cottonseed production rebounded during the past year, soybeans continue to make the big news. The 1968 soybean crop exceeded 1 billion bushels for the first time, but a sixth consecutive year of increased stock carryover is in prospect for next September. The phenomenal 10 per cent annual rate of growth in soybean use between 1953-65 has slowed to 3 per cent, but production has continued to soar. The slower rate of use reflects increased meal competition from fish meal and urea and oil competition from foreign supplies, especially sunflower seed oil. Surplus soybean oil supply will remain a price depressant in the 1968-69 marketing year, as little increase is expected in the domestic soybean crush. Several conditions, such as a smaller sunflower seed oil crop in Eastern Europe, a smaller Brazilian soybean crop, and continued strength in Japanese markets with lower import duties, should enable soybeans to register continued export gains this year, but the long-run outlook is for increased export competition.

FARM INCOME SUMMARY

The farm income situation of past years is shown clearly in Chart 5. Although farmers use more purchased inputs than ever before,

Table 1

BALANCE SHEETS FOR MAJOR CROPS

United States

(In Millions of Bushels)

	Wheat		Soybeans		Corn		Sorghum Grain	
	Marketing Year July 1, 1968-June 30, 1969		Marketing Year September 1, 1968-August 31, 1969		Marketing Year October 1, 1968-September 30, 1969		Marketing Year October 1, 1968-September 30, 1969	
Supply*	1967	1968	1967	1968	1967	1968	1967	1968
Carryover—beginning of year	425	537	90	167	823	1,146	244	292
Production and imports	1,525	1,570	973	1,080	4,723	4,375	766	739
Total Supply	1,950	2,107	1,063	1,247	5,546	5,521	1,010	1,031
Utilization†								
Domestic use (feed and industry)	64	125	581	594	3,351	3,418	567	580
Exports	761	670	267	280	625	697	159	160
Food	515	515	......	......	370	376	13	14
Seed	72	60	48	49	......	......	......	......
Total Utilization	1,413	1,370	896	923	4,346	4,491	730	754
Carryover—end of year	537	737	167	324	1,200	1,030	280	277

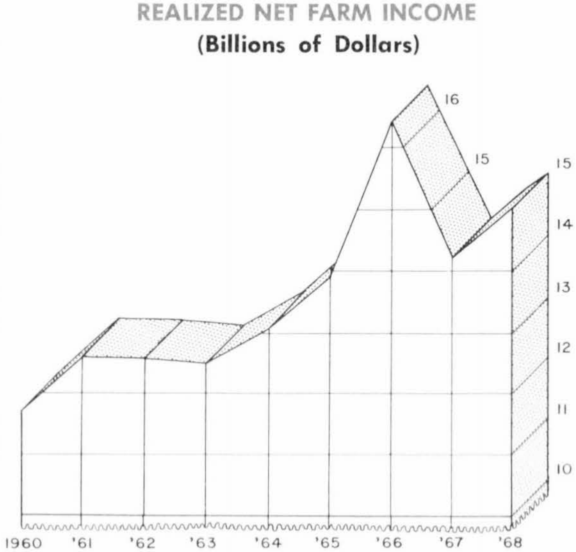
*Source: U. S. Department of Agriculture.
†Current year values are estimates.

and production expenses have continued to rise rapidly, gross farm receipts have risen somewhat faster than expenses in most recent years. Realized net farm income in 1968 will exceed the 1967 level by about $800 million—reaching $15 billion. Continued improvement into 1969 is possible if livestock prices do not succumb to the pressure of heavy red meat production and crop production is held close to anticipated demand.

Continued dependence on export markets taking the production of nearly one crop acre in four adds some vulnerability to future farm income levels. The favorable export situation of recent years will be hard to maintain, barring an international drought such as occurred a few years ago.

Chart 5

REALIZED NET FARM INCOME
(Billions of Dollars)



SOURCE: U. S. Department of Agriculture.

The Business Outlook for 1969

By Glenn H. Miller, Jr.

A Review of 1967-68

THE BEGINNING of this Nation's longest economic expansion, with its several early years —1961 through 1964—of comparatively slow growth and relative price stability, lies far behind us now. Even the rapid change of pace associated with the escalation of the Vietnam war is now relatively distant, although its direct effects and indirect repercussions continue to play an important part in the economic life of the Nation.

It will be remembered that the first half of 1967 was marked by an interlude of weakness in the economy. Current dollar gains in GNP were $4 billion and $8 billion in the first and second quarters (Table 1), while real GNP declined slightly in the first quarter and increased only $3.5 billion in the second quarter. Although in current dollar terms final sales rose $15.4 billion and $14.2 billion, respectively, investment in business inventories fell $11.4 billion and $6.1 billion to give the observed changes in GNP. The sizable inventory cor-

Table 1
GROSS NATIONAL PRODUCT IN CURRENT DOLLARS
Seasonally Adjusted Annual Rate
(In billions)

	1967				1968		
	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	1st Qtr.	2nd Qtr.	3rd Qtr.
Gross National Product	$772.2	$780.2	$795.3	$811.0	$831.2	$852.9	$871.0
Final Sales	763.8	778.0	789.9	802.7	829.1	842.1	863.5
Personal Consumption Expenditures	480.9	490.3	495.5	502.2	519.4	527.9	541.1
Durable Goods	69.8	73.4	73.1	74.2	79.0	81.0	85.1
Nondurable Goods	212.9	215.3	216.4	218.4	226.5	228.2	232.7
Services	198.2	201.6	205.9	209.6	213.9	218.7	223.4
Business Fixed Investment	83.5	82.7	83.3	85.0	88.6	87.0	90.1
Residential Structures	21.1	22.7	26.0	28.5	29.1	29.5	29.5
Change in Business Inventories	8.4	2.3	5.3	8.3	2.1	10.8	7.5
Net Exports of Goods and Services	5.2	5.1	5.4	3.4	1.5	2.0	3.3
Federal Purchases of Goods and Services	87.4	90.0	91.3	93.5	97.1	100.0	101.2
Defense	70.0	72.1	72.9	74.6	76.8	79.0	79.6
Other	17.4	17.9	18.4	19.0	20.3	21.0	21.5
State and Local Purchases of Goods and Services	85.8	87.2	88.4	90.0	93.4	95.6	98.4

SOURCE: U. S. Department of Commerce, Office of Business Economics.

rection did not nudge the economy into recession, primarily because of the strength in the consumer and government sectors of the economy. An additional feature of the economy's behavior in the first half of 1967 was a distinct and welcome slowdown in the rate of price increase. The first quarter's slight decline in real output and the increase of just over 2 per cent in the second quarter were associated with annual rates of price level increase, as measured by changes in the GNP deflator, of approximately 2.8 per cent and 2 per cent per year, respectively.

Concern for the weakening of economic activity was shown in this period by shifts in economic policy toward somewhat more stimulus. At the same time, however, economic analysts and policymakers—foreseeing a further sharp increase in the pace of growth following the retardation—were suggesting future fiscal restraint built around a surcharge on personal and corporate income tax liabilities.

Forecasts of a strong second half of 1967 were indeed borne out by the economy's performance in the last two quarters of the year. Current dollar GNP grew at an annual rate of nearly 8 per cent, or more than $15 billion, in each of these quarters (Tables 1 and 2). Final sales grew by somewhat less than in the first part of the year, but increasing inventory investment again became a positive contributor to overall growth. The pattern of growth in final sales was somewhat different in the last half year from that in the first two quarters, as business fixed investment and residential construction contributed relatively more, and consumer spending and government purchases relatively less, to the total increment in final sales. The relatively large quarterly increases in current dollar GNP in the last half of 1967 reflected a sharp advance in the rate of price rise (to annual rates of about 3.8 and 4.1 per cent in the third and four quarter, respectively), as well as a return to a rate of increase in real GNP (about 3.75 per cent per year) more nearly in line with the economy's estimated normal growth potential (Table 2).

Turning from this brief comparison of the first and second halves of 1967, a survey of the performance of the economy during the last half of 1967 and the first half of 1968 is enlightening. In the future, this period may be viewed as the "Boom of 1967-68," a period of extremely rapid growth in output and prices that led to the imposition in mid-1968 of that package of fiscal restraint included in the Revenue and Expenditure Control Act of 1968. At the most aggregative level, quarterly increases in current dollar GNP of $15 billion-plus for two quarters are noted, followed by two quarterly increases of $20 billion-plus (Table 1). In terms of annual rate percentage gains, there were two quarterly increases in GNP of about 8 per cent at an annual rate followed by two quarterly increases of about 10 per cent (Table 2). Reference to the distribution between real growth and price rise of the GNP gains in the first half of 1968 gives further credence to use of the word "boom." Prices, as measured by the GNP deflator, rose at annual rates of 3.5 per cent and 4.2 per cent in the first and second quarter, respectively, while real GNP increased by more than 6 per cent in each quarter (Table 2).

Several further points may be made concerning this performance. The pattern of change was different for final sales than for GNP. Final sales in the first quarter of 1968 were a whopping $26.4 billion—more than double that of any of the three other quarters, which were themselves very similar in magnitude. The first quarter increase was mainly attributable to an enormous $17.2 billion rise in personal consumption expenditures, and to large rises in government purchases of goods and services and in business fixed investment spending. A reduction of $6.2 billion in the rate of inventory accumulation, however, brought the GNP increase to $20.2 billion.

The second quarter increase in GNP outstripped that of the first by $1.5 billion, but the distribution between final sales and inventory investment was significantly different. Inventory building in the automobile industry and, more importantly, the accumulation of steel stocks in anticipation of a possible strike in the summer, contributed heavily to an $8.7 billion increase in inventory investment in the

Table 2
GROSS NATIONAL PRODUCT: QUARTERLY CHANGES
(In per cent per year)

	Current Dollars						
	1967				1968		
	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	1st Qtr.	2nd Qtr.	3rd Qtr.
Gross National Product	2.1	4.2	7.8	7.9	10.0	10.4	8.4
Final Sales	8.2	7.4	6.1	6.5	13.2	6.3	10.0
Personal Consumption Expenditures	6.1	7.8	4.2	5.4	13.7	6.6	10.0
Durable Goods	−7.3	20.6	−1.6	6.0	25.9	10.1	20.4
Nondurable Goods	6.9	4.5	2.0	3.7	14.8	3.0	8.0
Services	10.1	6.9	8.5	7.2	8.2	9.0	8.4
Business Fixed Investment	−3.3	−3.8	2.9	8.2	17.0	−7.2	14.4
Residential Structures	−11.0	30.3	58.2	38.5	8.4	5.5	......
Federal Purchases of Goods and Services	29.0	11.9	5.8	9.6	15.4	12.0	4.8
Defense	28.1	12.0	4.4	9.3	11.8	11.4	3.2
Other	32.3	11.5	11.2	13.0	27.4	13.8	9.6
State and Local Purchases of Goods and Services	15.0	6.5	5.5	7.2	15.1	9.4	11.6
	Constant Dollars						
Gross National Product	−0.8	2.1	3.8	3.7	6.4	6.2	5.1
Final Sales	5.7	5.6	2.1	2.0	10.0	1.6	6.9

SOURCE: U. S. Department of Commerce, Office of Business Economics.

quarter—about 40 per cent of the GNP increase of $21.7 billion. The second quarter increase in consumer spending was only about half that of the first in dollar amount, but still registered a sizable 6.6 per cent quarter-to-quarter rise on an annual rate basis.

The discussion of the preceding two paragraphs is in terms of current dollars. A glance at the constant dollar values of the various spending categories reveals that the comparative strength of first quarter final sales vis-a-vis the other three quarters was even greater in real terms, and that the constant dollar increase in total GNP was slightly larger in the first quarter of 1968 than in the second.

Measures of economic activity other than those from the national income accounts generally conformed to the picture of a strongly advancing economy in the period from mid-1967 to mid-1968 (Table 3). The index of industrial production rose steadily, gaining some of its impetus from the building of steel stocks. Increasing sales of domestically produced automobiles contributed to the surge in consumers' durables expenditures in the first half of 1968. The overall civilian unemployment rate, just under 4 per cent in the last half of 1967, fell further to 3.6 per cent for the first half of 1968. Extreme tightness in labor markets was underscored by an unemployment rate for all adult men that fluctuated narrowly in the 2.2 to 2.4 per cent range. Unit labor costs in manufacturing continued their upward movement in this four-quarter period, rising over 4 per cent. Prices rose at a distressingly rapid rate from the middle of 1967 to the middle of 1968: the GNP deflator (our broadest measure of price change) increased about 4 per cent, and the Consumer Price Index (CPI) more than 4 per cent. All in all, it was a period of rapid price inflation, fueled by both demand forces and cost pressures.

This was the path taken by the American economy in the four quarters immediately preceding the belated adoption of the Revenue and Expenditure Control Act of 1968. Signed by the President on June 28, 1968, this Act provided for a surcharge of 10 per cent on income tax liabilities of both corporations and individuals, effective for the former on January 1, 1968, and for the latter on April 1, 1968. The surcharge is to expire at the end of fiscal year 1969. The Act also provided for a reduction of $6 billion in Federal outlays for fiscal year 1969 below the levels estimated in the budget for that year—the budget sent to Congress in January 1968. Military spending for Vietnam operations, interest payments, veterans' benefits and services, and Social Security Act trust funds, were exempted from the expenditure reduction requirements; other specific exceptions were later legislated, and total Federal expenditures actually may turn out to be not much—if at all—below the original budget estimate.

The fiscal restraint program was aimed at slowing down the growth of demand to reduce pressures of demand on prices, and thus to decelerate the rate of price level increase. The surcharge began to affect individual income tax withholdings in mid-July, corporations began to pay on their obligations in the same month, and efforts to implement the Federal outlay reductions required by the Act were also underway in the third quarter. Primarily because of the expected impact of fiscal restraint, but also because of other factors such as an expected weakness in homebuilding and a prospective reversal from accumulation to liquidation of steel inventories, the standard midyear forecast was for a significant overall slowdown in the economy in the third quarter—a relatively small advance in economic activity as measured by GNP change—followed by further deceleration in the fourth quarter. Yet, as the third quarter went by, monthly statistics such as the remarkable increase in retail sales in July and the sharp rise in housing starts in the same month provided a preview of a third quarter rise in economic activity

Table 3
SELECTED MEASURES OF ECONOMIC ACTIVITY

	Unit	1967 1st Qtr.	1967 2nd Qtr.	1967 3rd Qtr.	1967 4th Qtr.	1968 1st Qtr.	1968 2nd Qtr.	1968 3rd Qtr.
Personal Income and Savings:								
Personal Income*	Billions of Dollars	614.8	621.6	633.7	645.2	662.7	678.1	694.0
Disposable Personal Income*	Billions of Dollars	534.2	541.5	550.0	559.6	574.4	586.3	592.6
Personal Savings Rate†	Per Cent	7.4	6.8	7.4	7.8	7.1	7.5	6.2
Production and Investment:								
Index of Industrial Production†	Index: 1957-59=100	157.2	156.0	157.2	159.7	162.1	164.0	164.6
Private Housing Starts*	Millions of Units	1.12	1.21	1.41	1.44	1.50	1.44	1.55
Plant and Equipment Expenditures*	Billions of Dollars	61.65	61.50	60.90	62.70	64.90	62.75	63.45
Automobile Unit Sales*	Millions of Units	7.16	8.11	7.57	7.44	8.19	8.44	9.01
Resource Use:								
Manufacturing Capacity Utilization Rate†	Per Cent	87.1	85.0	84.3	84.7	84.9	84.8	83.4
Civilian Unemployment Rate Rate—Total†	Per Cent	3.7	3.8	3.9	3.9	3.6	3.6	3.6
Civilian Unemployment Rate—Adult Men†	Per Cent	2.3	2.4	2.3	2.4	2.3	2.2	2.2
Unit Labor Costs in Manfacturing†	Index: 1957-59=100	104.5	105.5	106.9	106.9	108.7	109.5	111.6
Prices:								
Gross National Product Deflator*	Index: 1958=100	116.0	116.6	117.7	118.9	120.0	121.2	122.3
Wholesale Price Index—Industrial Commodities‡	Index: 1957-59=100	105.0	105.2	105.4	106.3	107.5	107.9	108.2
Consumer Price Index—Total	Index: 1957-59=100	114.8	115.6	116.8	117.8	119.0	120.4	121.9

*Seasonally adjusted annual rate.
†Seasonally adjusted.
‡Federal Reserve grouping.

much greater than generally expected. The data for the third quarter as a whole also corroborated what had appeared to be taking place.

Gross national product in the third quarter rose $18.1 billion in current dollars, somewhat less than the quarterly increases in the first half of the year, but still larger both in dollar and percentage terms than the quarterly rises in the last half of 1967. The increase in real GNP continued at a high annual rate of 5.1 per cent and the GNP deflator rose at the only-slightly-reduced rate of 3.4 per cent per year. Furthermore, the GNP increase was held down by a rate of inventory accumulation smaller than that of the second quarter; final sales in current dollars in the third quarter rose by a very large $21.4 billion. Business fixed investment, net exports, and government purchases of goods and services all contributed to the rise in final sales, although Federal purchases —both defense and nondefense—rose considerably less than the average increase for the preceding six quarters. But it was the increased spending by consumers that drew much of the attention of economic analysts and policymakers.

Total personal income swelled nearly $16 billion in the third quarter—more than the second quarter's dollar increase, and equal to the 9-plus per cent annual rate increase of the preceding period. But personal taxes also rose sharply in the third quarter, primarily because of the impact of the tax surcharge. As a result, third quarter disposable personal income rose only $6.3 billion—considerably less than the quarterly increase in the first half of 1968, and even below the quarterly rises of 1967. Yet, personal consumption expenditures mounted $13.2 billion — second only in this expansion to the huge increase in the first quarter of 1968. Spending for services rose by about the recent trend value, while purchases of nondurable goods rose by an amount near the high end of the range established during the current expansion. Both categories rose in the third quarter at a rate of about 8 per cent per year. Durable goods spending, however, rose at a rate of about 20 per cent per year, or more than $4 billion. This very substantial increase in consumer spending for durables largely reflected domestic automobile sales during the quarter at a nine million unit annual rate—a rate not approached since the first quarter of 1966.

Quarterly data on income, taxes, and consumption indicate that the observed pattern of consumer behavior was obtained by a reduction in the rate at which persons save from disposable income—a drop in the personal savings rate. That rate had been greater than 7 per cent in six of the seven quarters since the last quarter of 1965 and well above the average of about 6 per cent recorded for 1964, 1965, and most of 1966. But in the third quarter of 1968 the personal savings rate fell to 6.3 per cent of disposable personal income from the second quarter rate of 7.5 per cent, a change very nearly large enough to offset the restraining influence of the tax increase on consumer spending.

Thus, the performance of the economy in the third quarter of 1968 was sufficiently buoyant for many to question the efficacy of the fiscal package enacted at the end of June in restraining the growth of demand sufficiently to retard the recent unacceptable rate of increase in the general price level. Therefore, discussions of the performance of the economy in 1969 revolve around expectations concerning the response of demand growth to fiscal restraint in the months ahead.

Following the enactment of the fiscal restraint legislation, a particular overview of the expected performance of the economy in 1969 emerged as a standard, or consensus, forecast. It suggested that 1969 would be a year of more moderate economic expansion, with much of the retardation attributable to slower growth in personal consumption expenditures and in government purchases of goods and services. The slowdown, which was expected to become evident in the third and fourth quarters of 1968, was anticipated to bring a moderate—not an abrupt—decline in the rate of GNP growth. Quarterly GNP growth for all of 1969, according to the standard forecast, was expected to be more rapid in the second half of the year than in the first. If the expected moderation in real GNP growth occurred, the pressure of demand on the economy's resource base would be reduced and a reduction in the rate of increase of the general price level would be expected.

Almost from the time of its promulgation, the so-called standard forecast has been subjected to extensive second-guessing—including many expressions of doubt from those originally adhering to the general view. For one thing, there is an underlying feeling of uncertainty about economic affairs due to exogenous factors such as the Vietnam peace talks and the future course of the war, and the change in national administration with its possible influence on economic policy. There was also the continued rapid advance in economic activity in the third quarter of 1968 at a pace much faster than many analysts and policymakers had expected. As already noted, this caused some wavering in the widely held belief that moderation in the rate of economic advance would quickly follow the application of fiscal restraint. Then the likelihood emerged that the fourth quarter would also fail to display the degree of economic retardation that earlier had been expected of it, as (at this writing) automobile sales remained strong, housing starts stayed at a relatively high rate, the results of the new capital spending plans surveys were released, and unemployment rates plunged to the lowest levels of this expansion. A continued strong upward movement of prices associated with these events, and evidence of widely held inflationary expectations, add to the difficulty involved in wholehearted acceptance of the standard forecast.

Outlook for 1969

The continued strength of the economy through the last half of 1968 has had the effect of reducing an earlier concern for a possible "economic overkill" in the first half of 1969, to speculation about the possibility of "economic overcool," and finally to consideration of the contingency that the emerging pattern of economic activity may not result in the needed lessening of price inflationary forces. The following brief comments on the anticipated behavior of major economic sectors may help to account for this swing in opinion.

BUSINESS FIXED INVESTMENT

In the time since the main outlines of the standard forecast were drawn up, results have been published from the two major surveys of future capital spending plans by U. S. business: the McGraw-Hill fall survey of preliminary capital spending plans and the Commerce Department-Securities and Exchange Commission survey of anticipated expenditures for new plant and equipment. The plant and equipment spending surveys have a less inclusive coverage than the business fixed investment category of the national income accounts—for example, investment spending in agriculture and the professions and by nonprofit institutions is included in the latter but not in the former. These plans are preliminary and hence subject to review and change in the light of future developments. Nevertheless, the plant and equipment survey results have been reasonably good indicators of overall investment spending.

The McGraw-Hill survey, first of the two to be released, reported that U. S. business plans to spend between 7 and 8 per cent more on new plant and equipment in 1969 than in 1968. This planned increase, though greater than those for 1967 and 1968, is still relatively modest, especially in real terms. Companies surveyed expect the prices they will pay for new plant and equipment to rise by an average 4 to 5 per cent—which is similar to the price increases of the past two years. It is likely that some of the strength in next year's capital spending plans comes from the desire to modernize plants and reduce costs in the face of rising labor costs—in spite of the fact that capacity utilization rates have been relatively low for some time.

The Commerce-SEC survey, conducted in October and November, reports spending plans only through the first half of 1969. Yet, the results published there provide food for thought concerning the quarter-to-quarter movement in business capital spending plans. For one thing, the level of spending anticipated for the fourth quarter of 1968 was revised upward from that anticipated in the August survey. Thus, capital spending (on a seasonally adjusted annual rate basis) may turn out to be $2 billion-plus higher in the last quarter of 1968 than was formerly expected and nearly $4 billion greater than the actual third-quarter level, a development likely to add substantially to the total economic advance in the fourth quarter. Then, although the anticipated advance from full-year 1968 to the expected seasonally adjusted annual rate for the second quarter of 1969 is 9 per cent, the quarterly breakdown shows a strong increase in the first quarter, followed by a moderate decline in the second. If realized, capital spending increases of this size and timing certainly will not be contributing to the forces of slowdown in the fourth quarter of 1968 and the first quarter of 1969, but will be an expansionary force.

RESIDENTIAL CONSTRUCTION

Housing starts, and therefore residential construction spending, will reflect several sets of pressures in 1969. Fundamental demand for housing is very strong, supported by a relatively high level of new household formations, relative under-building of housing units for several years, and the need for replacement of net removals from the existing housing inventory. On the other hand, the supply of new units is likely to continue to be constrained by rising construction costs and, more importantly, by the limited availability of mortgage and other financing. Even in the face of expected supply constraints, housing starts are likely to be above their 1968 level. If events dictate moves that relax the supply constraints on homebuilding, that sector could well show a much greater increase in 1969.

FEDERAL GOVERNMENT PURCHASES OF GOODS AND SERVICES

Federal purchases of goods and services for national defense have grown more slowly beginning with the second quarter of 1967 than they did from the second half of 1965 through the first quarter of 1967. This reflects, of course, the difference between the rapid buildup associated with the escalation of the Vietnam war and a situation of maintaining a high level of spending once achieved. The slowing down or leveling off of advance indicators of defense activity—such as contract awards and obligations incurred—which has been observable for some time now, supports the conclusion that defense purchases are unlikely to rise much in 1969. Third quarter data show relatively small quarterly rises for both defense and civilian nondefense spending by the Federal Government (Table 2). Such relatively low rates of increase in Federal purchases now appear likely to extend into 1969—barring any major change in international relations.

PERSONAL CONSUMPTION EXPENDITURES

It has already been noted that increases in personal consumption expenditures ranged from relatively large to enormous during the first three quarters of 1968. A change to much more modest growth in consumer spending is necessary if economic activity is to grow at a significantly slower pace in 1969.

The following factors generally were cited in the standard forecast in support of expectations of slower growth in consumer spending. A reduced rate of economic expansion presumably would mean less rapid personal income growth, and a drop in the savings rate of a magnitude similar to that of the third quarter of 1968 probably will not soon be repeated. Disposable personal income growth will be retarded further in the first half of 1969 as an increase in Social Security tax payments goes into effect in January and as individual taxpayers pay the remainder of their 1968 personal income tax liabilities at settlement time—a remainder that will be larger than usual because the retroactive part of the surcharge was not covered by withholding. Finally, it appears that the continuation of the surcharge past its scheduled expiration date of June 30, 1969, is very much an open question. Yet here, as in other spending categories, the fulfillment of the standard forecast is not a foregone conclusion.

Nondurable Goods and Services

The relatively sizable and regular quarterly increases in spending for consumer services shown in Tables 1 and 2 compose a pattern not confined to the period shown there. Such a pattern of upward momentum has been characteristic of the postwar period, and probably will be maintained in 1969. Although the quarterly increases in nondurable goods spending have fluctuated more in size than those for services, there has been only one quarter in this expansion when nondurables purchases failed to rise. Together, these two classes of consumer purchases probably will continue to rise in line with increases in disposable personal income.

Durable Goods

This class of consumer spending does show marked quarterly variation; quarter-to-quarter changes have ranged from large increases to small increases to not infrequent declines. This behavior arises from the relatively easy postponability of most durables purchases, of which automobiles and parts and furniture and household equipment make up more than 80 per cent. Durable goods purchases were quite strong in 1968, due primarily to very strong automobile sales, and, in 1969, will depend to a large extent on the strength of automobile sales. Whether the high level of sales attained in the summer and early fall will be maintained through the rest of the 1969 model year, of course, is not yet known. A definite weakness, and perhaps even some quarterly declines, in personal consumption expenditures for durable goods would seem to be built into the anticipation of a more moderate rate of overall expansion for 1969.

Whether such weakness in spending for consumer durables actually occurs and makes its expected contribution to an economic slowdown is far from certain, however. Further surges in the use of consumer credit and a faster than expected rise in economic activity, and hence in personal income, might well provide the basis for future increases in durables purchases that would help sustain the expansion and a too-rapid rate of price increase.

OTHER EXPENDITURE CATEGORIES

Business Inventory Investment

The importance of changes in the rate of accumulation of business inventories has been shown already. The prospects for inventory investment in 1969 are such that it may have less impact on changes in overall economic activity than in either 1967 or 1968. Very large inventories accumulated in 1966 had to be worked off through the first half of 1967. In addition, the special factors underlying changes in inventory investment in 1968 —such as the accumulation and liquidation of steel stocks—will be absent in 1969. Inventory investment variation in 1969 should be more directly related to normal consumption and production patterns, and may be expected to show less wide swings from quarter to quarter. However, changes in inventory investment often confound plausible expectations.

State and Local Government Purchases of Goods and Services

Many of the most pressing demands upon our resources in this decade and the next have come, and are likely to come, through channels traditionally associated with the powers and responsibilities of state and local governments. This has meant a relatively steady increase in state and local purchases of goods and services, which will probably continue throughout 1969. However, a reduced rate of growth in Federal outlays would mean some slowdown in grants to state and local governments, which might in turn reduce their ability to increase expenditures.

Net Exports

Net exports of goods and services, though of great importance for our balance of payments situation, make up only a very small proportion of GNP. If a more moderate rise in GNP produces a slower growth in imports and if a reduced rate of price increase aids the competitive position of our exports, net exports may well contribute somewhat more to GNP growth in 1969 than in 1968.

RESOURCE USE AND PRICES

Two often-used indicators of the degree of pressure of economic activity on the resource base are the rate of capacity utilization in manufacturing and the unemployment rate. The capacity utilization rate was at 90 per cent or above in each of the four quarters of 1966. After declining fairly sharply during the overall slowdown in the first half of 1967, this rate has continued to drift downwards, reaching about 83 per cent in the last part of 1968. Although the overall rate recently has been comparatively low, certain industries, of course, have been operating at considerably higher rates. Low rates of capacity use generally tend to restrain the pace of business spending for new plant and equipment. With no apparent shortage of capacity, the anticipated increases in capital outlays described earlier may well reflect a desire by firms to attempt cost reduction via plant modernization, in the face of pressures on labor costs springing from the extreme tightness in manpower markets.

The overall unemployment rate declined sharply in 1965 and 1966. In 1967, the increases in labor force and employment were similar and the unemployment rate remained virtually the same as in the preceding year. The 1968 rise in employment will probably be close to or slightly smaller than that for 1967, but, when matched against a significantly smaller increase in the size of the labor force, it produces an unemployment rate for the year of about 3.6 per cent—the lowest recorded since the early 1950's. As 1968 drew to a close, however, the monthly overall unemployment rate dropped to its lowest point in 15 years and the rate for adult men equaled the lowest rate in the history of this series.

If output does grow relatively slowly in 1969, labor productivity gains will not be great. But the average advance in labor compensation also should be a little smaller in 1969. Special factors such as 1968's minimum wage increase will be absent, and there will be few major wage negotiations compared with 1968. Although considerable wage-cost-push pressure remains built into the system, the rate of increase in labor costs should be more moderate in 1969.

The number of persons in the primary working age group is projected to grow by larger annual increments in the next few years than it did in the 1961-67 period. Although reduced economic activity tends to reduce labor force participation somewhat, a reduced pace of economic advance would combine with slightly faster labor force growth to lessen the pressures in the labor market over the short term. Some of these effects could be felt in 1969, when unemployment rates may be moderately higher. Should the economy perform more strongly, however, unemployment rates are not likely to change much and labor market tightness will continue to exert strong pressure on the general price level from the cost side.

Table I
GNP IN CURRENT DOLLARS (SAAR)
(In billions)

	1968 4th Qtr.
Gross National Product	887.4
Final Sales	876.8
Personal Consumption Expenditures	546.8
Durable Goods	85.1
Nondurable Goods	233.7
Services	228.0
Business Fixed Investment	94.3
Residential Structures	31.6
Change in Business Inventories	10.6
Net Exports of Goods and Services	1.0
Federal Purchases of Goods and Services	101.7
Defense	80.0
Other	21.7
State and Local Purchases of Goods and Services	101.2

Table II
GNP: QUARTERLY CHANGES
(In per cent per year)

	1968 4th Qtr. Current Dollars
Gross National Product	7.5
Final Sales	6.2
Personal Consumption Expenditures	4.2
Durable Goods	--
Nondurable Goods	1.7
Services	8.2
Business Fixed Investment	18.6
Residential Structures	28.5
Federal Purchases of Goods and Services	2.0
Defense	2.0
Other	3.7
State and Local Purchases of Goods and Services	11.4
	Constant Dollars
Gross National Product	3.4
Final Sales	1.9

*Seasonally adjusted annual rate. †Seasonally adjusted. ‡Federal Reserve grouping.

Table III
SELECTED MEASURES OF ECONOMIC ACTIVITY

	Unit	1968 4th Qtr.
Personal Income and Savings:		
Personal Income*	Bil. $	708.2
Disposable personal income*	Bil. $	602.4
Personal Savings Rate†	Per cent	6.8
Production and Investments:		
Index of Indus. Prod.†	1957-59=100	167.3
Private Housing Starts*	Mil. units	1.58
Plant and Equipment Expenditures*	Bil. $	n.a.
Automobile Unit Sales*	Mil. units	8.82
Resource Use:		
Manufacturing Capacity Utilization Rate†	Per cent	84.1
Civilian Unemployment Rate—Total†	Per cent	3.4
Civilian Unemployment Rate—Adult Men†	Per cent	2.0
Unit Labor Costs in Mfg.†	1957-59=100	111.8
Prices:		
Gross National Product Deflator*	1958=100	123.5
Wholesale Price Index—Industrial Commidities ‡	1957-59=100	109.0
Consumer Price Index—Total	1957-59=100	123.3