# The Business Situation

Many important business indicators have recently shown improvement from their April performance, when strikes and poor weather contributed to declines in production and sales in several sectors of the economy. While the current pace of the expansion still remains below the very sharp and strongly inflationary first-quarter advance, the pressure of aggregate demand continues to place the economy's productive resources under considerable strain. The price situation clearly remains a cause for concern. Although prices of farm products have ceased their sharp uptrend and have even declined somewhat in recent months, other prices continue to move up. Over the first five months of the year industrial wholesale prices climbed at an annual rate of 3.5 per cent, on average, and there appears to have been a further rise in June.

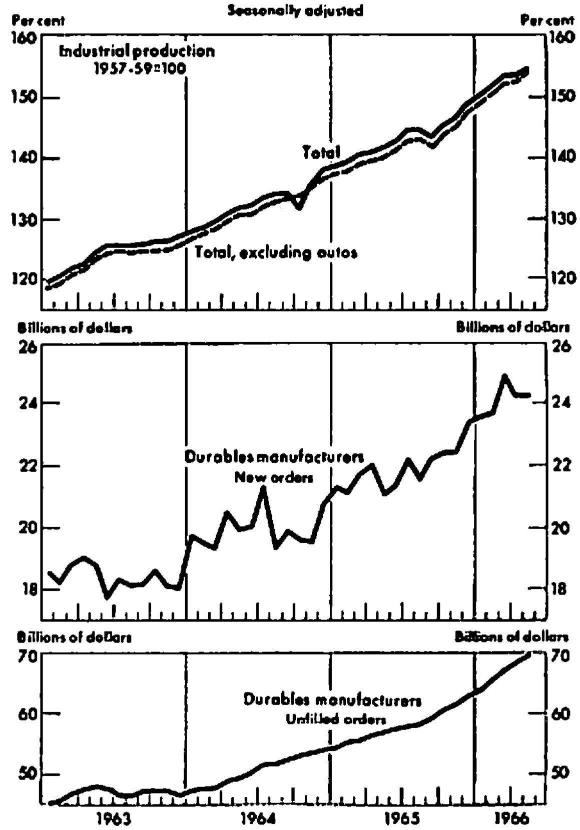
One unfavorable element in the outlook for price behavior is evidence suggesting that the rate of advance in labor productivity has been slowing down recently. Moreover, past increases in consumer prices, expanded profits, and generally tight labor market conditions may lead organized labor to press for relatively substantial settlements in the important wage negotiations that are coming up in the months ahead. Wage rates in nonorganized industries are also under pressure. Against this background, the past stability in labor costs per unit of manufacturing output—a key factor accounting for the relative price stability over much of the current expansion—may be difficult to maintain.

### CURRENT ECONOMIC DEVELOPMENTS

Industrial production, as measured by the Federal Reserve Board's index, rose by a sizable 0.8 per cent in May (seasonally adjusted), despite a further decline in automobile assemblies (see Chart I). This advance partly reflected a recovery from the effects of strikes during April in the coal-mining and railroad industries, which were a major factor in holding the April rise to a small 0.2 per cent. Nevertheless, the May expansion in production was broadly based: output of consumer goods other than automobiles advanced, iron and steel activity moved higher, and production of equipment rose by a strong 2.2 per cent to a level some 17 per cent above a year earlier.

Lagging automobile sales and high inventories led to a large cutback in the production of new cars in May.

Chart I
RECENT BUSINESS INDICATORS
Seasonally adjusted




Source: Board of Governors of the Federal Reserve System; United States Department of Commerce.

Several reasons for the weakness in sales have been noted, including the exceptionally high rate of auto sales in the first quarter, the reimposition of the January excise tax cut on automobiles, and the recent public discussion of the car-safety problem. These factors may have only a temporary dampening influence on car sales, and a clearer picture of the basic demand for automobiles should emerge after the 1967 models come on the market. Auto sales did improve materially from May to June on a seasonally adjusted basis, but the near-term outlook for auto production remains affected by the currently high level of inventories. At the end of June, dealer inventories of new cars represented about sixty days' sales at that month's selling pace, largely unchanged from the May inventory-sales ratio which was the highest figure in five years. Accordingly, while new-car assemblies in June rose by about 2 per cent to a seasonally adjusted annual rate of 8.7 million units, a large reduction in automobile assemblies is now scheduled for July when some plants will be closed earlier than usual for the annual model changeover.

Reflecting the reduced rate of new-car output, automotive orders for finished steel products declined sharply in May. Overall steel demand held firm at most major mills, however, as defense orders were reportedly taking up much of the automotive slack. Despite a possible further decline in shipments to car manufacturers through early summer, steelmakers apparently remain generally optimistic about near-term prospects, and anticipate continuing good steel demand for appliances, construction, and capital goods as well as a stream of orders for military purposes. In June, steel output was near the high annual rate of roughly 140 million tons (seasonally adjusted) turned out in May.

Other major suppliers to the auto industry are also feeling the effects of the cutback in assemblies. In several cases, however, the resulting sales loss is being partially offset by heavy demands for trucks, railroad rolling stock, and capital equipment generally. To some producers, moreover, moderation from the recent pace in the flow of orders would not be altogether unwelcome in view of heavy backlogs of orders and the need to provide for equipment maintenance that has been deferred during recent periods. In the case of the steel industry, for example, reports in trade publications indicate that a heavy flow of orders during the summer could create problems, since equipment repairs are "long overdue".

The overall volume of new orders received by manufacturers of durable goods was roughly unchanged in May, remaining at the high monthly average of the first quarter of the year (see Chart I). New orders received by manufacturers of machinery and equipment continued to reflect the strength of capital spending, and in May were nearly 18 per cent above May 1965 bookings. For all durables manufacturers combined, incoming orders stayed well ahead of shipments, and the backlog of unfilled orders on these producers' books registered another large advance. This gain brought the stock of unfilled orders to a level equal to three months' shipments at the present monthly rate, up by about a week from the start of the year.

Manufacturers' inventory plans also point to continued near-term strength in production. According to a Commerce Department survey taken in the middle of the second quarter, manufacturers anticipated adding \$1.3 billion to the book values of their inventories during that quarter. While such a gain would be below the quarterly inventory additions of \$1.6 billion to \$1.7 billion realized since mid-1965, the survey found producers expecting to raise the accumulation rate back up to \$1.6 billion in the third quarter. Moreover, during the last year and a half, manufacturers' inventory projections for the ensuing quarter have tended to underestimate actual accumulation—in some cases by more than \$1 billion. The planned additions to inventory stocks in the third quarter are about in line with manufacturers' sales projections for that quarter. If both sets of expectations are realized, inventories at the end of September will approximate 1.6 months of sales, representing little change from the relationship prevailing since early 1965.

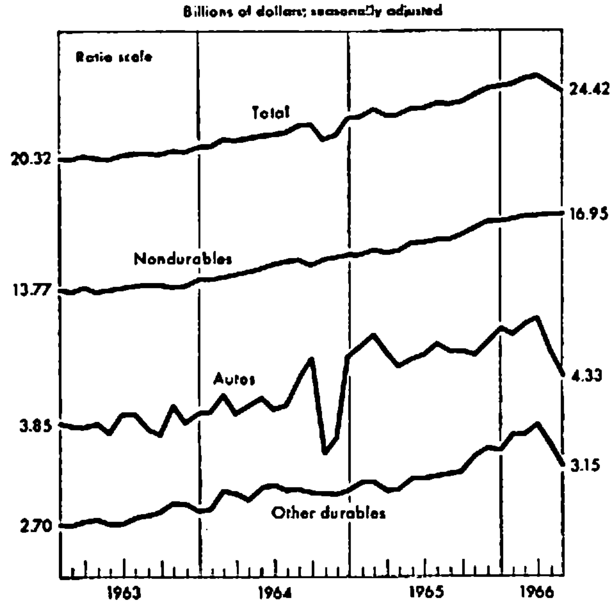
The strength in overall production during May showed up in the long hours put in by production workers in the manufacturing industries. To be sure, a reduction in hours at automobile plants did produce a small 0.1 hour decline (seasonally adjusted) in average weekly hours worked. Nevertheless, the workweek remained at a high 41.4 hours, around the level prevailing since the fourth quarter of last year. Overtime hours continued at the record high first-quarter rate of 4.1 hours a week. The number of workers on factory payrolls, however, rose by only 58,000 (seasonally adjusted) in May, about one half the strong average rate of increase recorded in the first quarter of the year. Some of the slackening in factory employment growth reflected the weakness in the automotive industry, although small declines in employment were noted in a few other manufacturing groups. With small employment gains reported in wholesale and retail trade, together with a sharp drop in construction workers, total nonfarm payroll employment increased in May at about half the rapid first-quarter rate.

The further growth in nonfarm payroll employment in May resulted in another gain in total personal income, but as in the case of employment, the monthly advance was considerably below the average increase experienced in the first quarter. The slower growth of income, in turn, was partly responsible for the weakness in consumer demand during May, when retail sales fell for the second consecutive month. As in April, lower auto sales accounted for a sizable portion of the decline, although consumer expenditures for other durable goods apparently were also lower. Spending on nondurables was largely unchanged from the record level of the previous month.

Along with the more modest rate of gain in personal income, and the increase on May 1 in the level of personal income tax withholdings, some of the moderation in spending undoubtedly also reflects a reaction to the exceptionally heavy buying in previous months. Consumer outlays for automobiles (as noted earlier) as well as purchases of other durable and nondurable goods were at unusually high levels in the first quarter of the year (see Chart II), and the ratio of saving to disposable income declined significantly. Consumer spending now appears to be adjusting to a more normal relationship to incomes. Part of the enlarged outlays on nondurables in recent past months was attributable to higher food prices; the present leveling-off in these prices may now be holding down the dollar advance in nondurables purchases.

In another area related to consumer demand, outlays for new residential construction were up moderately in May; however, some near-term easing appears in process in this sector, reflecting the higher cost and reduced availability of mortgage money. In May, seasonally adjusted private nonfarm housing starts and newly issued building permits fell to around their lowest levels of the current expansion. These indicators are heavily influenced by weather conditions and hence tend to be highly variable from month to month. Nevertheless, the annual rate of housing starts during the first five months of the year was about 2.5 per cent below the 1965 total, while permits dropped about 3.6 per cent. Much of the recent weakness in the residential sector has been offset, however, by strong gains in commercial and industrial construction. Indeed, aggregate spending for new construction during the first five months of the year, measured at an annual rate, was more than 6 per cent ahead of the total in 1965. Given the buoyancy of business capital spending plans for 1966, commercial and industrial construction will likely make up for continued sluggishness in new home building.

Chart II
RETAIL SALES
Billions of dollars; seasonally adjusted




Note: Latest data plotted are based on advance reports.
Source: United States Department of Commerce.

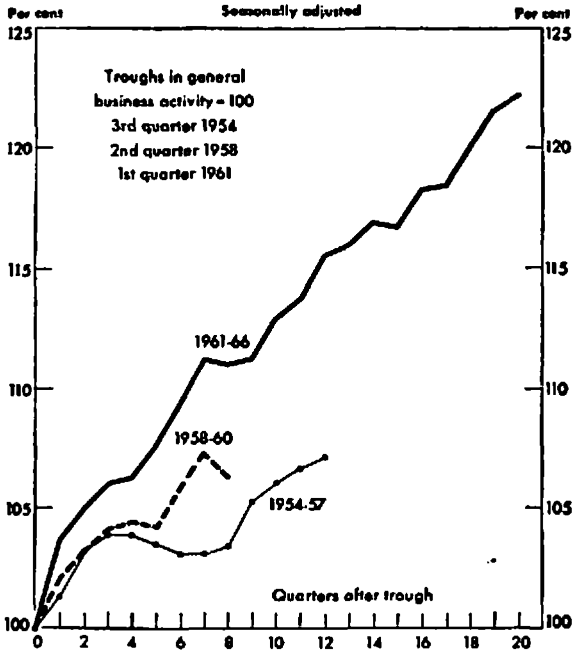
## PRODUCTIVITY TRENDS AND THE OUTLOOK FOR PRICES

Certainly one of the most noteworthy features of the current business expansion has been the sharp and unusually prolonged rise in output per manhour (see Chart III). This growth of productivity has made an important contribution to the high degree of price stability that prevailed until late 1965, and may therefore have been one of the more important factors contributing to the record length of the expansion. Recent developments, however, have raised questions about the sustainability of high rates of productivity gain, while at the same time the outlook for continued moderation in the size of wage increases has dimmed appreciably. Because forthcoming wage contracts in important "pace-setting" industries will be negotiated against the background of sharply higher consumer prices, low unemployment, expanded profits, and large order backlogs, some observers foresee wage settlements in excess of the Administration's guideposts for noninflationary increases. These guideposts are intended to approximate the long-run trend of productivity growth and currently call for wage increases of no more than 3.2 per cent per year. If productivity growth falls below this rate of increase while wage settlements go substantially beyond it, labor costs per unit of output will increase. Moreover, as long as currently strong demand conditions persist, businesses would be very likely to pass on part or all of any increases in labor costs in the form of higher prices. Thus, the behavior of productivity in the period ahead will be important in determining whether or not price increases

Chart III

INDEX OF OUTPUT PER MANHOUR
TOTAL PRIVATE ECONOMY

Seasonally adjusted




Note: Latest quarter plotted in the current expansion is the first quarter of 1966.
Source: Based on unpublished estimates from the United States Bureau of Labor Statistics.

remain within tolerable limits.

Output per manhour in the private sector of the economy has advanced at an average annual rate of 4.1 per cent since the beginning of this expansion, and the total rise over this period has amounted to 22 per cent.[1] In comparison, productivity advanced at an annual rate of only 3.1 per cent during the 1958-60 business expansion, and by an even smaller 2.3 per cent annual rate in the 1954-57 upswing.

The available evidence suggests that the faster rate of advance in overall productivity in the current expansion relative to the two prior cyclical upswings has been due to a more rapid growth of productivity outside of manufacturing. Indeed, the 4.3 per cent rise in productivity in manufacturing during the current expansion has only roughly equaled the average of the two preceding expansions. While direct data on other nonfarm sectors—i.e., services, utilities, trade, and mining—are lacking, productivity growth in these industries as a group has apparently been more rapid in the current advance than earlier. Moreover, gains in farm productivity since early 1961, at about 5 per cent per year, have been notably above the roughly 3 per cent and 4 per cent rates recorded in the 1954-57 and 1958-60 upswings, respectively.

In previous expansions, productivity gains have tended to be substantially slower after the economy has reached relatively full resource utilization than in the earlier stages of the upturn. This tendency probably reflects in part the fact that once the slack in the economy has been taken up, additional output requires drawing more heavily upon less qualified workers and either reactivating older plant and equipment or working newer facilities beyond the point of greatest efficiency. The comparatively high unemployment rates and low rates of capacity utilization that prevailed during the first years of the current expansion may partly account for the maintenance of productivity gains at so high a rate for so long a period. More recently, the margin of unused resources has shrunk, and there appear to have been some signs of a slackening-off in productivity growth. After rising by 3.6 per cent in 1964, total private output per manhour advanced by only 2.8 per cent in 1965 and slowed down further to a 2.4 per cent annual rate in the first quarter of this year. The current shortages of many types of skilled labor and relatively high rates of plant utilization may well tend to restrain productivity growth in the future.

At the same time that productivity gains have narrowed, tightening labor market conditions and rising consumer prices are adding to wage pressures. The unemployment rate averaged a low 3.8 per cent in the first five months of this year, down from a 4.6 per cent rate in 1965 and the lowest rate since 1957. Since the end of last year, the unemployment rate for married men—the main reservoir of skilled and experienced workers—has averaged slightly more than 1.8 per cent, the smallest figure in the eleven-year history of this series. With respect to prices, the consumer price index advanced by 2.7 per cent in the year ended May 1966, after increasing by a moderate 1.2 per cent on average in the first four years of the expansion. Taking into account also the increase in social security contributions last January, the purchasing power of the take-home pay of many workers has declined since May 1965.

There is thus a real danger that both labor supply and

[1] In this section, the quarterly data on labor productivity for the entire private economy and for its nonagricultural and agricultural subsectors are unpublished estimates from the Bureau of Labor Statistics. Labor productivity data for manufacturing are unpublished estimates computed by the Federal Reserve Bank of New York. Estimated manhours are based primarily on data derived from the Government's monthly survey of payroll employment.

price factors may push up wage demands in the coming round of negotiations. While the collective-bargaining calendar for the remainder of this year is light, many contracts are reopening in 1967, covering workers in such key fields as the automobile, machinery, trucking, rubber, communications, paper, food products, and apparel industries. Additional gains in productivity will continue to moderate the effect of higher wages on unit labor costs. As already indicated, such an offset is not likely to be so important as it was earlier in the upswing. Nevertheless, the currently rapid growth in industrial capacity gives hope that the rise in productivity will not slow down as much as it did in previous periods of high resource utilization.