# The Business Situation

Business activity appeared to be gaining momentum as the economy moved through the second quarter. While the effects of the inventory readjustment continue to be felt in some sectors of the economy, the most recent data indicate a widespread strengthening of demand forces. May saw a strong and broadly based rise in new orders for durable goods, a further gain in residential construction, and—according to the advance report—the third consecutive increase in retail sales. At the same time, the latest survey of capital spending plans pointed to renewed growth in such outlays in the second half of the year. Prices rose on a broad front in May. The consumer price index climbed 0.3 per cent in both April and May after several months of relative stability. Food prices moved up for the first time in nine months, while prices for other nondurable commodities, durable goods, and services all showed substantial increases. Rising prices of farm and food products pushed the wholesale index up by 0.5 per cent in May, and preliminary data point to an increase of about the same magnitude in June.

## PRODUCTION, INCOME, AND CONSUMER DEMAND

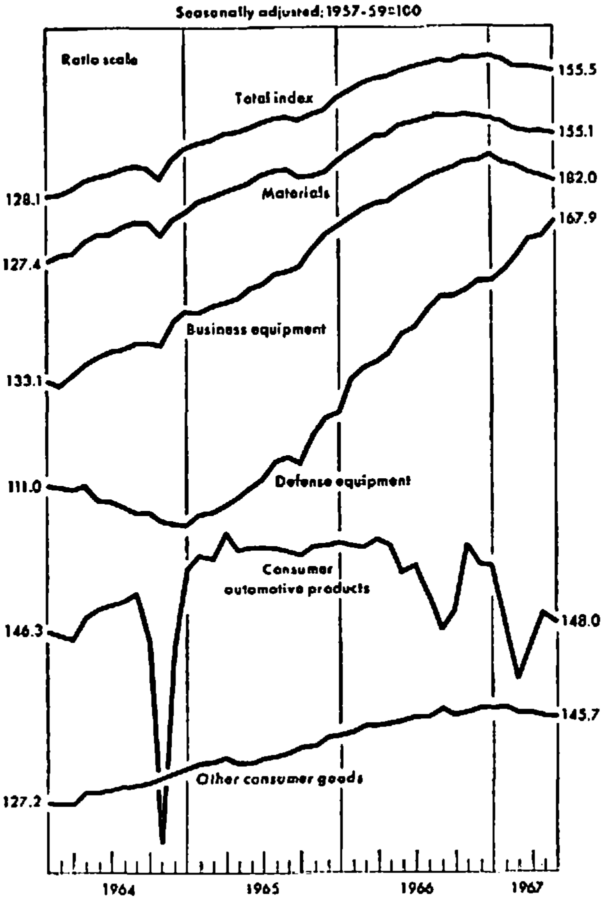
Industrial output eased slightly further in May. The Federal Reserve Board's seasonally adjusted production index declined by ½ percentage point to 155.5 per cent of the 1957-59 average (see Chart 1). Output of industrial materials continued to slacken and business equipment production also fell somewhat further, while overall production of consumer goods changed little. Automobile manufacturers assembled new cars at a seasonally adjusted annual rate of about 7⅔ million units, matching the April pace. However, partly because of a strike in the rubber industry, the overall production index for autos and related products dropped back a bit after having risen sharply in the two preceding months. The aggregate output of other goods for consumer markets was virtually unchanged in May. Television set production rose during the month, a gain which contrasted with the steep decline during the earlier months of 1967. May witnessed a further substantial advance in the output of defense equipment. In the course of the first five months of 1967, the index of defense equipment production rose at an annual rate of about 24 per cent, which represented a slight acceleration from the already rapid growth recorded in 1966.

The process of adjusting business inventories to bring them into better alignment with sales has played a major role in dampening the pace of industrial production this year. Trade firms have made some actual reductions in the level of their stocks, while manufacturers have added to their inventories at a slower rate. In May, the increase in manufacturers' inventories was the smallest in more than two years and was only about half as large as the average accumulation of the two preceding months. Though some further adjustments may occur in the trade sector, the problem of excessive inventories now appears to be centered in manufacturing. At the close of the first quarter, according to a Commerce Department survey taken in May, almost one third of total inventories in manufacturing was in the hands of firms that felt their stocks were too high relative to sales and orders. The survey also found,

Chart I

**INDUSTRIAL PRODUCTION**

Seasonally adjusted; 1957-59=100




Note: Indexes for defense equipment and nonautomotive consumer goods were calculated at the Federal Reserve Bank of New York from data published by the Board of Governors of the Federal Reserve System.

Source: Board of Governors of the Federal Reserve System.

however, that manufacturers were quite optimistic about sales prospects in the second and third quarters. In apparent reflection of this optimism, producers reported that they were planning further additions to inventory in both quarters, though at a rate slower than that of the first quarter and far below the pace in the second half of last year. Thus, there may well be some additional cutbacks in the rate of inventory accumulation and even further liquidation in some lines of business. These adjustments, however, are likely to be considerably smaller than those in recent months and should therefore exert less drag on economic activity.

The near-term outlook for production was brightened by the large rise in May of new orders for durable goods. Following some months of virtual stability, the flow of orders increased in May by a strong 7½ per cent. The advance was partly due to a sharp rise in orders received by the defense-oriented industries—that sector accounted for about one third of the overall rise—but sizable gains were widespread throughout other lines of durables manufacturing. Machinery and equipment producers reported a third consecutive improvement in orders volume, with bookings in May reaching the highest level since December. The general expectation that the investment tax credit and accelerated depreciation allowances would be restored retroactive to March probably accounted for some of the sharp increase in new orders. At the same time, total shipments of durable goods rose appreciably in May, recouping most of the April decline. The shipments volume was nevertheless substantially less than the large inflow of orders, and the backlog of unfilled durables orders expanded by a very large $1 billion. This was the first increase this year in the orders backlog, which had dropped by almost $2½ billion in the first three months of 1967 and then held about unchanged in April.

The continued sluggishness in May of activity in manufacturing and in some lines of construction was reflected in some further easing of demands for labor. This, in turn, dampened the growth of personal income. Total wage and salary payments in manufacturing were down for the second month in a row, with a strike in the rubber industry accounting for about half of the decline. In the private sector as a whole, employee income was about unchanged, but government wage and salary disbursements continued to grow at a substantial rate. Overall income growth in May was boosted by a sizable rise in payments for medical care under the social security program. The increase in total personal income, while double the April rise, was nevertheless somewhat smaller than the monthly average in the first quarter.

Preliminary data indicate that retail sales volume rose in May for the third consecutive month. The expansion of sales from February to May, at an annual rate of more than 9 per cent, represented the first sustained advance in nearly a year. The May rise was centered in sales of nondurable goods. In the durables sector, outlets selling motor vehicles and related goods reported a further increase in dollar volume, but sales in other durables lines moved lower. Sales of new domestically produced cars, which had recovered strongly in March and April, held about unchanged in May at an annual rate of approximately 7½ million units. A renewed surge in June raised sales by nearly 15 per cent to an annual rate of more than 8½ million units.

### BUSINESS INVESTMENT PLANS AND CONSTRUCTION

The results of the latest survey of business capital outlay plans are in line with earlier indications that such spending will show renewed strength in the second half of 1967, following a dip in the first two quarters (see Chart II). According to the May survey by the Commerce Department and the Securities and Exchange Commission, business spending on plant and equipment in 1967 will total $62.4 billion, a modest gain of 3 per cent over the 1966 figure. The survey finding represents a downward revision from the 4 per cent increase indicated by the previous Commerce-SEC survey taken in February. Virtually all this downward revision reflected a reduction in estimated outlays in the first half of the year in nonmanufacturing industries. Outlays in the third and fourth quarters combined are now expected to average 5 per cent, at an annual rate, over the first half.

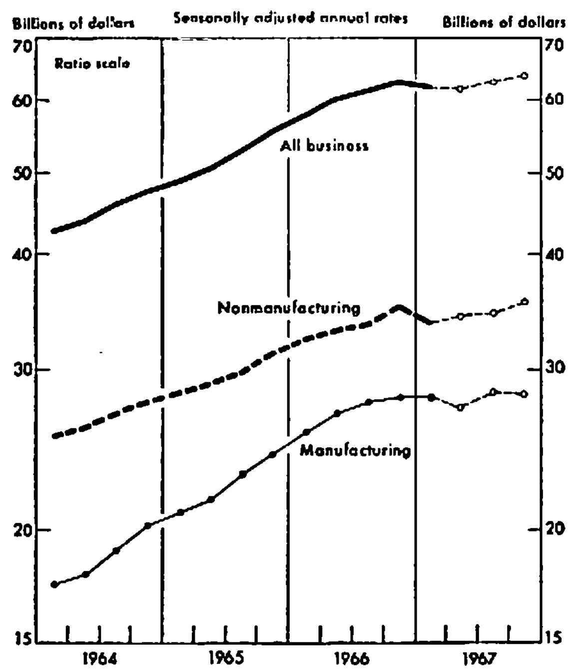
Total capital spending in the first quarter of 1967 is reported to have been at an annual rate of $61.7 billion, more than $1 billion under the fourth-quarter rate. At the time of the February survey, it was anticipated that first-quarter outlays would be only very slightly below the fourth-quarter rate. Following an expected small further decline in the April-June quarter, renewed growth is planned, with capital spending running at a $63.2 billion rate in the second half.

Within the total for all businesses, manufacturers plan to expand plant and equipment spending by 3½ per cent this year. A majority of individual manufacturing industries anticipate that their capital expenditures in 1967 will be larger than last year, with the sharpest increases planned by the machinery and petroleum industries. Reduced spending, however, is foreseen in several industries, including motor vehicles. In the nonmanufacturing sector, the most striking feature of the survey was the very large drop in spending planned by the railroads, a decline from 1966 amounting to almost $0.5 billion or nearly 25 per cent. It is generally believed that the suspension last fall of tax incentives for investment was felt particularly heavily by the railroads as well as by commercial firms, which also intend to reduce spending this year. Other nonmanufacturing industries anticipate increases in spending that, while smaller than the gains posted in 1966, are considerably stronger than those projected by the manufacturing sector.

The latest Commerce-SEC survey was taken before the actual passage of the legislation restoring the 7 per cent investment tax credit and the use of accelerated depreciation allowances. The general expectation that the incentives would be restored was probably reflected in some of the plans reported in the survey. The restoration itself, however, has already accelerated spending in some lines. For example, immediately following the President's signature of the restoration law in mid-June, there was a strong surge in railroad orders for rolling stock. According to industry sources, such orders in 1967 had been running at only about one fourth of the year-earlier volume. Moreover, the pressure of labor costs may well provide some additional stimulus to capital investment in coming months.

Industrial and commercial building activity has been relatively weak in recent months, reflecting the general slackening of business fixed investment. In contrast, residential construction has been improving significantly. The seasonally adjusted rate of housing starts in May recorded a strong further advance, rising by more than 11 per cent over the April pace, with gains reported in most regions of the country. At the same time, there was another increase in the number of housing units authorized by new building permits, and the value of residential construction contract awards reached the highest point in a

Chart II
ACTUAL AND ANTICIPATED PLANT AND EQUIPMENT SPENDING




Note: Figures shown for the second, third, and fourth quarters of 1967 are estimates from the May Commerce-SEC survey.
Source: United States Department of Commerce; Securities and Exchange Commission.

year. The upturn in residential activity thus far in 1967 has been stronger than was apparently expected by many observers. Housing starts in the first five months of the year averaged 1.2 million units at a seasonally adjusted annual rate, equal to the 1966 total and almost 25 per cent above the depressed pace in the fourth quarter of last year. Moreover, the restoration of accelerated depreciation allowances on apartments (and other buildings) costing more than $50,000 may well provide a further stimulus to residential construction.