The Business Situation

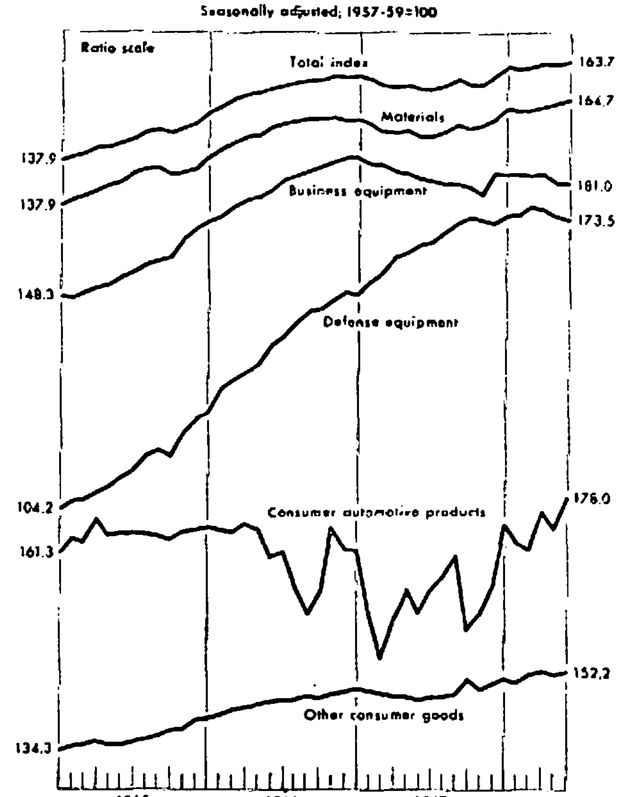
Business activity was strong as the first half of 1968 drew to a close. Production and employment were at record levels, but cost and demand pressures on prices remained excessive. At the same time, the United States balance-of-payments deficit continued to be substantial and the international financial markets were subject to renewed uncertainties. Against this background, the Congress passed and the President signed the long-awaited fiscal restraint package, including a 10 per cent surcharge on personal and corporate income taxes and a reduction in budgeted Federal spending. These measures should begin to relieve the demand pressures in the economy quite promptly. Bringing existing cost pressures under control will, however, be a slower and more difficult matter.

Industrial production moved up sharply in May from an April level that had been restrained in part by civil disorders. Automobile production provided a major stimulus to May output, and the assembly rate continued to run at a high level in June. With output expanding, the flow of income to consumers registered a sharp gain, paced by wages and salaries in manufacturing. Retail sales also advanced in May, as sales of automobiles and other consumer durables posted good gains. Although the number of housing units started fell sharply in May, this series is quite erratic and building permits for new housing remained at a high level. Labor market conditions remained extremely tight, with the unemployment rate holding at its fifteen-year low of 3.5 per cent in May. Consumer prices advanced again at a rapid 4 per cent annual rate in May, while wholesale prices, according to the preliminary report, climbed at a 2 per cent rate in June.

PRODUCTION, ORDERS, AND CONSTRUCTION

Industrial output in May reached a new high. The Federal Reserve Board's seasonally adjusted production index rose 1.2 percentage points to a record 163.7 per cent of the 1957-59 base (see Chart I). Auto assemblies—up 10 per cent to an annual rate of 9.4 million units—gave the manufacturing index a substantial boost, and assemblies remained at a high 9.3 million unit rate in June. Automobile production has been running ahead of sales, as auto makers build up inventories in anticipation of a steel strike. Output of other consumer goods also expanded strongly in May. The production of industrial materials advanced sharply, since the index of iron and steel output climbed 4.2 percentage points. A high level of operations in the steel industry is expected to continue to bolster the industrial production index in June, as pressure builds to fill orders before the August strike deadline.

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. Indexes are not plotted in rank order.

Source: Board of Governors of the Federal Reserve System.

The rate of materials output in May was also strengthened by the further recovery of copper production from strike-reduced levels. Equipment production edged downward because the defense equipment component, which has been falling since February, continued to decline. Business equipment production, however, remained at its April level.

The pace of inventory accumulation is providing strong support for industrial production. In contrast to the first quarter of 1968—when a strong rise in consumer demand apparently held inventories below intended levels—April saw businesses adding substantially to stocks. Total inventories of manufacturing and trade firms expanded by a seasonally adjusted $1.3 billion in April, compared with a monthly average of only $370 million in the first quarter. Most of the expansion was accounted for by manufacturers and retailers. At the retail level, the growth in auto dealers' stocks was responsible for about two thirds of the increase. While data on inventories in trade firms is not yet available for May, manufacturers' inventories did expand further in May but at a more moderate rate. The April step-up in inventory investment was associated with a modest rise in the inventory-sales ratios of retailers and of durables manufacturers, but the slower May inventory expansion, coupled with a sizable gain in sales, brought the manufacturers' ratio down to the lowest level since 1966.

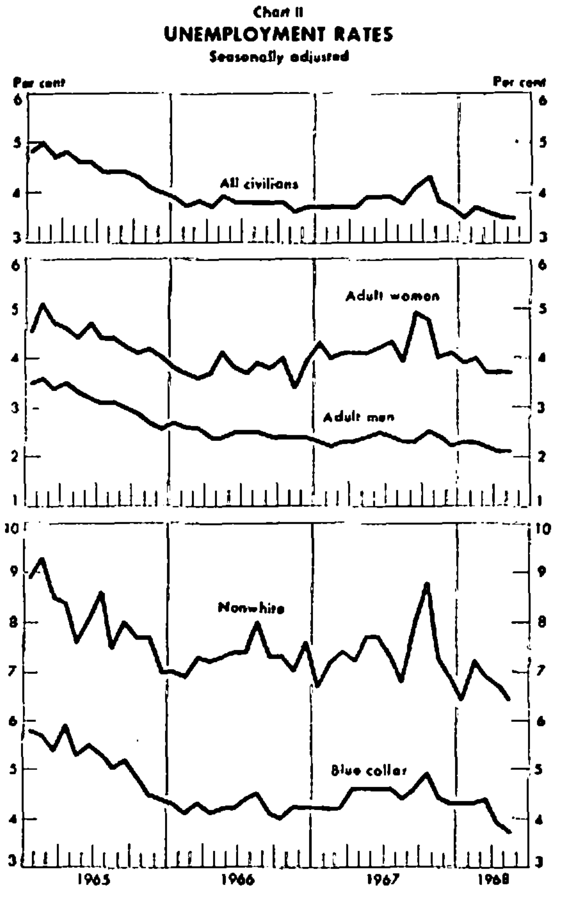
The volume of new orders received by durables manufacturers rose 1.7 per cent in May to a seasonally adjusted $25.6 billion. Gains in the primary metals, machinery and equipment, and auto industries led the advance, while the defense-oriented industries experienced a decline. The so-called "defense" orders series includes all orders received by the aircraft industry, and the strong March increase and the subsequent sharp April and May declines were mainly due to a heavy concentration of commercial aircraft bookings in March. Excluding the defense products industry, durables orders advanced by 5 per cent in May. New orders excluding transportation equipment have remained roughly on a plateau this year, somewhat below the extraordinary December peak but significantly above earlier months of 1967. Since durables manufacturers' shipments in May exceeded the volume of new orders, the orders backlog dropped back somewhat from its April peak, but remained at a high $80.9 billion.

The latest Government survey of business capital spending plans indicates that 1968 outlays on plant and equipment will be 6.7 per cent above last year's level, compared with an anticipated 5.8 per cent increase reported by the preceding survey three months earlier. The new survey, taken by the Department of Commerce and the Securities and Exchange Commission in late April and early May, shows 1968 plant and equipment expenditures at a record $65.8 billion. The latest survey findings, as well as the solid $2.2 billion gain registered in the first quarter, indicates that plant and equipment spending has made a substantial recovery from the pause following the 1964-66 capital investment boom. The survey indicates outlays dipping slightly in the second quarter to an annual rate of $64.6 billion, and then rising by $1.45 billion in each of the final two quarters. While the planned expansion of capital outlays in 1968 is widespread, projected gains are largest in nonmanufacturing industries. This concentration is understandable in view of the relatively moderate rates at which manufacturing capacity has been utilized during the past year.

Indicators of activity in the residential construction sector—which had shown considerable strength in the first four months of this year—gave conflicting signals in May. Private nonfarm housing starts, an admittedly erratic series, fell sharply from the high April level to a seasonally adjusted annual rate of 1.3 million units. Some decline in housing activity might well be expected in view of the relatively tight conditions that have been prevailing in the mortgage market over past months. Nevertheless, the number of building permits issued for new private housing declined only moderately in May, suggesting that a sustained sharp fall in housing starts is probably unlikely. Moreover, private nonfarm residential construction outlays continued to advance in May. The recently passed tax and spending package may relieve some of the pressures in the capital markets and make a larger supply of funds available to institutions specializing in mortgage lending.

EMPLOYMENT, INCOME, AND CONSUMER DEMAND

The number of workers on the payrolls of nonagricultural establishments was unchanged from April to May, as strikes in the construction and telephone industries offset increases in wholesale and retail trade, services, and state and local government—the three categories of employment that consistently have shown the most growth in the last few years. While manufacturing payroll employment was virtually unchanged from the April level, the manufacturing workweek bounced back from a sharp dip in April which had reflected the effects of civil disturbances and religious holidays. The workweek in manufacturing averaged a seasonally adjusted 40.6 hours, up from 40 hours in April; overtime averaged 3.4 hours, up from 2.8 hours in April. The increases brought the workweek and overtime back about in line with their March levels.



Source: United States Bureau of Labor Statistics.

Unemployment in May remained at 3.5 per cent of the civilian labor force, the lowest rate since 1953. The unemployment rate has fluctuated in the narrow range between 3.5 and 3.7 per cent for the past six months (see Chart II). It has been nearly fifteen years since the rate remained for so long a period at such a low level. Tightening of the labor market over the past year has been clearly reflected in declining unemployment rates for specific groups of workers. The rate for adult men, unchanged in May from April's 2.1 per cent, was at the lowest level since June 1953; it was 2.4 per cent a year ago. The adult women's rate, also unchanged from April at 3.7 per cent, was down from 4.1 per cent a year earlier. The decline in unemployment has improved the position of some of the groups that had been suffering rather persistent joblessness. The blue-collar unemployment rate of 3.7 per cent was down from 3.9 per cent in April and 4.6 per cent a year earlier. Joblessness among nonwhites fell back in May to the record low 6.4 per cent registered in January of this year, down from 6.7 per cent in April and 7.7 per cent a year ago. The fact remains, however, that the nonwhite unemployment rate has persistently been about twice as high as that for white workers.

Rising wage rates helped boost personal income in May by $4.2 billion to a seasonally adjusted annual rate of $674.0 billion. The largest advance occurred in the category of wages and salaries that rose $2.9 billion, more than double the April increase which had been dampened by the telephone industry strike and by civil disturbances. According to the Commerce Department, about half of the May wage and salary rise was accounted for by manufacturers' pay boosts. A longer workweek also contributed to the wage and salary gain in manufacturing.

Retail sales apparently resumed their upward climb in May with a 1.1 per cent advance to a near-record level of $27.9 billion, seasonally adjusted, according to the preliminary report of the Department of Commerce. The April decline, which occurred against a background of civil disorders, was the first since last October. The May gain was paced by a 2 per cent advance in the automotive group. Car sales climbed again in June to 8.8 million units at a seasonally adjusted annual rate. Reflecting the rise in consumer spending, consumer instalment credit in May advanced sharply, largely as a result of a rapid increase in automobile and personal loans.

PRICE AND COST DEVELOPMENTS

Prices and costs continued their upward spiral in May. The consumer price index rose at an annual rate of 4.0 per cent—bringing the gain since May 1967 to 4.1 per cent, the largest annual increase in sixteen years. All the major components of the consumer price index showed large increases in May. The nonfood commodities index advanced at an annual rate of 3 per cent, while prices of services rose at a 4½ per cent annual rate, as health, housing, and recreation costs moved higher. The upturn in wholesale food prices this year was reflected in a substantial rise in retail food prices.

At the wholesale price level, preliminary data for June indicate a further 2.2 per cent annual rate advance to 108.7 per cent of the 1957-59 base, with industrial wholesale prices renewing their upward movement. After nine months of large increases, industrial commodities prices eased in May, as copper prices fell from strike-inflated levels. In June, however, this index turned upward again, rising by 0.2 percentage point. Agricultural prices show a mixed pattern in June. Farm products prices, which had jumped

4.7 percentage points from December to May, fell back 1.3 percentage points in June, but wholesale prices of processed foods and feeds continued to climb strongly.

Labor costs rose again in May. The combination of a modest decline in output per man-hour and an increase in hourly compensation, in part due to an increase in overtime payments, pushed the index of unit labor costs in manufacturing up 0.2 percentage point to a record 109.6 per cent of the 1957-59 average. Unit labor costs in manufacturing have advanced at an annual rate of 5½ per cent in the first five months of this year, following the rapid 4 per cent increase in 1967. Bringing mounting labor costs under control is a difficult but important goal of the recently enacted fiscal restraint measures.