The Business Situation

Despite continuing signs of some moderation, the economy remains vigorous and inflationary expectations are still strong. Industrial production registered a substantial gain in May, primarily because of sizable advances in the output of business equipment and materials. Moreover, the latest survey of 1969 business capital spending plans indicated that the aggregate volume of anticipated outlays was initially little affected by the late-April proposal for repeal of the investment tax credit, undoubtedly in part because of the desire to offset rising wage costs. It is therefore to be expected that the demand for equipment will continue to expand. Furthermore, steel production was strong again in June, according to early evidence, while auto assemblies, receiving a boost from a brisk sales pace, rebounded swiftly from the strike-depressed levels of the previous two months. On the other hand, overall sales at retail outlets have been displaying a moderating trend for many months, and with pressures easing somewhat in the labor market the growth of personal income has apparently slowed. As was to be expected, private housing starts moved lower in May for the fourth consecutive month, largely in response to increasingly tight mortgage market conditions. In addition, new orders placed with manufacturers of durable goods dropped, lending support to the view that a good part of the April surge had resulted from the ordering of business equipment in anticipation of the move to repeal the investment tax credit.

Business demands on the credit markets remain intense, even though the prime lending rate of commercial banks moved up in early June by a full percentage point to a record 8½ percent and interest rates generally are at the highest levels in this century. The uncertainty that developed in the late spring over the prospects for extension of the income tax surcharge may have strengthened expectations of persistent inflation. Nevertheless, the extremely tight financial situation—in part the result of a highly restrictive monetary policy—should ultimately slow the growth of real economic activity sufficiently to lead to a less inflationary environment.

PRODUCTION, ORDERS, AND HOUSING

A strong further expansion in business equipment output led to a substantial advance in industrial production during May. The Federal Reserve Board's aggregate production index recorded a gain of a full percentage point to reach a seasonally adjusted 172.8 percent of the 1957-59 average (see Chart I). The rise in equipment output was centered in goods for industrial and commercial business, where a vigorous growth trend emerged some months ago. Other components entering into the business equipment index—farm, freight, and passenger transportation equipment—have been much less buoyant. Gains in the output of iron and steel and most other materials also contributed to the overall May advance, while production of goods for consumer markets and of defense-related equipment was essentially unchanged. The steel industry has been benefiting from strong demand conditions both at home and abroad. The spring and early summer seasonal slack in orders and production appears to be quite mild this year, and available evidence points to a further advance in seasonally adjusted output in June.

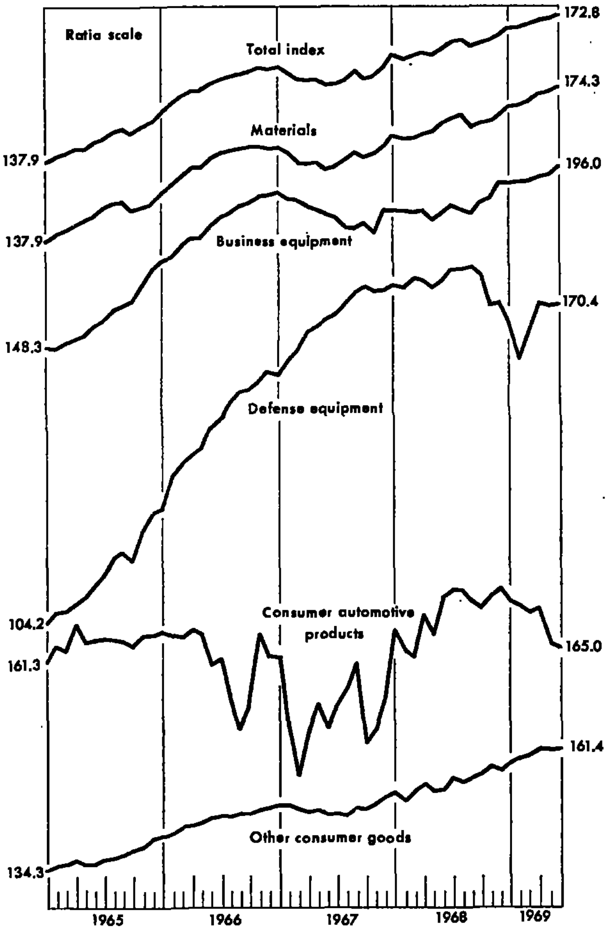
Business equipment output since the summer of 1968 has paralleled the surge in capital spending. The vigorous growth of equipment production implies that a good part of the capital spending uptrend reflects an enlarged volume of physical investment and not simply rising prices. Indeed, the step-up in equipment purchasing seems to be the main factor in the recent rapid expansion of overall capital spending. Outlays for commercial and industrial construction have moved downward, even before allowing for rising prices, after a sharp gain around the turn of the year. When the figures are adjusted for price movements, they indicate that the real volume of commercial and industrial construction was relatively stable throughout 1968 and has fallen in 1969 to a level below the average for last year.

Excluding automotive products, aggregate output of goods for consumer markets was little changed again in

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. Data for latest four months are subject to revision.

Source: Board of Governors of the Federal Reserve System.

May, while the production index for automobiles and related goods fell a bit further. The May reduction in the automotive index, as in April, was largely due to the depressing effect of strikes in the auto industry. In both months the actual number of new cars built was substantially below the volume originally scheduled. With normal operating conditions generally restored in June, output rebounded sharply to a seasonally adjusted annual rate of about 8.6 million units, compared with about 7.6 million in each of the preceding two months. The unexpected curtailment of assembly operations, coupled with a strengthening in sales, has reduced inventory holdings of auto dealers. It appeared several months ago that dealers' stocks might well be excessive relative to actual and prospective sales, but the relationship has since shown a marked improvement.

The volume of new orders received by durable goods manufacturers fell back in May by an amount almost as large as the sharp April advance. From \$30.9 billion in April, orders declined in May to \$29.9 billion. It is apparent that the volume of orders has moved along an essentially horizontal path since last October, when bookings reached \$30.3 billion on the strength of a single sharp jump of \$1.9 billion. The April advance was in large measure due to a surge in orders for railroad equipment, though most major durables industries shared in the improvement. The May decline included a steep cutback in railroad equipment ordering but, like the April gain, was broadly spread through the durables sector. The plateau in aggregate durables orders since last fall can be seen also in the orders figures of most of the major durables industries.

The huge addition to manufacturers' inventories in May, \$980 million, was the largest since August 1966. Because the rise was accompanied by a commensurate expansion in sales, it left the ratio of inventories to sales at the same level as a month earlier. However, this maintenance of overall balance was not reflected in component figures. The inventory-sales ratio of durables manufacturers rose substantially as a result of a very large buildup in stocks and a slight decline in shipments. For nondurables manufacturers, a large gain in sales reduced the ratio noticeably despite a sizable accumulation of inventories. It is too early to judge the significance of the huge increase in stocks, but a survey of manufacturers' inventory and sales expectations conducted by the Commerce Department in May indicated that manufacturers were indeed planning a rise in inventories in excess of expected sales during the second and third quarters. These plans seem to have reflected, at least in part, anticipations of additional boosts in materials prices. Presumably, the recent further rise in the cost of financing stocks, signaled by the June hike in the prime rate, will cause many of these firms to review their inventory positions.

The leading indicators of residential construction activity continued to trend downward in May. The pace of private housing starts declined for the fourth consecutive month, reaching a seasonally adjusted annual rate of just over 1.5 million units, and the rate of building permit authorizations for new units also slipped. At its May level, the starts rate was just equal to the 1968 average.

The May reduction in starts, rather surprisingly, was the result of a steep drop in starts of multi-unit housing that more than offset an upturn in starts of single-family homes. While single-unit starts have occasionally fluctuated sharply from month to month, the trend of their movement since early 1967 has been generally horizontal, with recent months suggesting a clear downturn. In view of the progressive tightening of the mortgage conditions facing home buyers, and steep increases in construction costs, pressures on single-family home construction are especially great, and it is possible that the substantial May jump in single-unit starts was largely a reflection of the month-to-month volatility that characterizes the starts data. In the multi-unit sector, where most building is of structures with five or more units, starts in recent months had been averaging as high as 700,000 units annually, an exceptionally high rate by historical standards. The demand for apartments has been very strong due to the recent sharp uptrend in household formation, and the supply of mortgage credit for apartment construction has been well sustained.

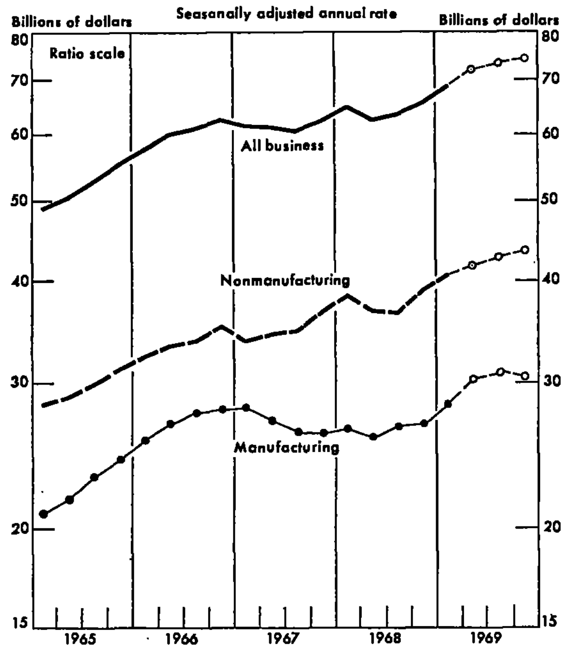
CAPITAL INVESTMENT PLANS

The strength of business expectations is evident in the capital spending plans reported in the latest quarterly Government survey, taken in late April and May. In the three months separating that survey and the preceding one, credit became very much costlier and harder to obtain, and there were also firm and frequent official reaffirmations of the intent to pursue restrictive economic policies as far as necessary in the battle against inflation. Moreover, on April 21 the President asked an apparently receptive Congress for repeal of the tax credit for investment in capital equipment. Yet, when the Commerce Department and the Securities and Exchange Commission surveyed business spending plans, they found only a very modest cutback in the size of the anticipated 1969 increase. The survey results point to an $8.1 billion rise this year in plant and equipment outlays, representing a 12.6 percent advance; the February survey had indicated an increase of $8.9 billion, or 13.9 percent. The aggregate spending rate is expected to increase throughout the year, but the gains anticipated after the second quarter are moderate (see Chart II), suggesting that capital investment will provide little expansionary thrust to the overall economy in the latter half of the year.

The Commerce-SEC surveys canvass anticipated spending, not the reasons underlying the spending plans. However, the strength of the planned 1969 rise certainly must reflect substantial business optimism about the outlook for demand and little concern over the prospects for any significant slowdown in economic activity. Undoubtedly, plans are also influenced by a desire to offset rising costs and the shortages of skilled manpower. The pervasiveness of inflationary expectations poses a major problem to be overcome in the progress toward the vital goal of halting inflation.

The May spending survey found that first-quarter outlays were at a seasonally adjusted annual rate of $68.9 billion, up by $3 billion from the fourth quarter but close to $3 billion below the figure anticipated in February. In view of the fact that the February survey had indicated an extraordinary spending rate advance of nearly $6 billion, it is very likely that much of the shortfall from that expectation was due to delivery problems and related difficulties. In several industries where first-quarter spending was reported to have fallen short, second-quarter plans were scaled up, but little if any revision was made in estimates for the full year. This suggests that in these industries—including mining, nonrail transportation, nonelectrical machinery manufacturing, and the aggregate of commercial and communications firms—some spending

Chart II
ACTUAL AND ANTICIPATED
PLANT AND EQUIPMENT SPENDING



Note: Figures shown for the second, third, and fourth quarters of 1969 are estimates from the May Commerce-SEC survey.
Sources: United States Department of Commerce; Securities and Exchange Commission.

was in fact pushed from the first to the second quarter.

On the other hand, the recent survey indicated that in many industries where first-quarter spending was below anticipations the shortfall is not being made up, and that in a number of sectors plans have been revised down not only for the first half of the year but also for the second. The most notable retrenchment was reported by the railroads, and may well reflect a particular sensitivity to the proposal for repeal of the investment tax credit. Following two years of sizable declines in investment spending, the railroads had planned in February a rise of nearly 30 percent this year, but the May survey reported a cutback to 15 percent, which is still a large gain.

The survey found a notable difference in spending plans between durables and nondurables manufacturers. Virtually every nondurables industry showed a cutback from the 1969 plans reported in February, with the downward revisions spread throughout the year. In most durables manufacturing industries, however, first-quarter spending exceeded the February anticipation, and at the same time plans for the remainder of the year were revised upward. The steel industry was the only marked exception, and even there the downward revision of second-half plans was modest. If expectations of rising costs of planned capital investment contributed to the upward revisions by durables producers, the different pattern in the reports from the nondurables sector is surprising.

THE CONSUMER SECTOR

Retail sales volume declined by 1 percent in May, following a recovery of almost 2 percent in April, according to revised data. May sales were lower at both durable goods and nondurable goods stores. The overall decline carried the retail sales estimates further along the rather flat trend that has been apparent since last September. Indeed, in view of the distressingly rapid advance in consumer prices, the retail sales figures probably imply some drop in physical volume since early last fall.

Retail outlets in the broad automotive goods group reported a very small decline in total dollar volume in May, but unit sales figures indicate that buying of new cars picked up substantially. Unit sales of domestic models rose by 4 percent, from an annual rate not far above 8 million cars in April to a pace of 8½ million in May. The sporadic strikes that cut into production in these two months apparently caused some dampening of sales as a result of model shortages, particularly in April. To some extent, the strong further sales gain in June—to an annual rate of 9 million units—represented a rebound from the effects of the strikes. For the three months April through June, sales of new domestic-model cars were at a seasonally adjusted annual rate of 8½ million units. This was up moderately from the average pace registered in the preceding three months as well as from that in the first half of 1968, but substantially below the exceptionally strong showing through most of last year's second half when sales ranged narrowly around an annual rate of 9 million units.

A slowing in employment growth dampened the expansion of personal income in both April and May. In the latter month, the seasonally adjusted annual rate of personal income rose by $3.8 billion, a gain slightly larger than April's but noticeably below the figure of some $5 billion that was typical during the preceding twelve months. The slowing in growth was centered in wages and salaries, which account for the bulk of total income. Expansion of aggregate personal income does not, of course, necessarily imply that individuals are, on average, experiencing a rise in real purchasing power. On a per capita basis, disposable personal income, which is defined as personal income less taxes and is estimated quarterly, continued to expand at a fairly strong rate in the first quarter. However, after allowing for the effect that rising prices have on purchasing power, per capita disposable income in the first quarter showed little change from the early-1968 level; and, for a considerably longer span of time, there has been little growth in the purchasing power of the average nonfarm worker's "take home" pay.

Following a span of four or five months in which the labor force and civilian employment showed exceptional strength, some moderation developed in April and May. From November through March, both employment and the labor force had been registering seasonally adjusted increases far in excess of the normal growth trend. The expansion of employment was especially sharp, and the unemployment rate held during the winter months at a very low 3.3 percent. Employment growth was only about seasonal in March, however, and in April and May it fell short of seasonal expectations. Though the seasonally adjusted civilian labor force also declined in the latter two months, the unemployment rate moved up to 3.5 percent. A similar picture is found in figures on the number of persons reported as working in nonagricultural establishments. The growth in such employment tapered off in the spring after several months of very strong advance. Though these developments suggest an easing of conditions, the labor markets remain very firm. In any event, some readjustment could be expected after the recent period of exceptionally rapid employment growth. Figures for the summer months will be of particular interest in view of the expected heavy seasonal influx of young people seeking both temporary and permanent employment following the end of the school year.

PRICE DEVELOPMENTS

Consumer prices continued to climb in May, although the gain was far smaller than in the preceding two months. The overall index rose at an annual rate of some 3¾ percent, still excessive but down markedly from the March-April average pace of almost 9 percent. At the wholesale level, on the other hand, the uptrend of the aggregate price index accelerated. In recent months the major force behind this advance has been the steep increase in prices of agricultural commodities. The index for industrial commodities has been stabilizing meanwhile and, on the basis of preliminary data, did not rise at all in June.

The May slowdown in the growth rate of the consumer price index was shared by each of the major index components. The price level for services rose in May at an annual rate of 6 percent; while sizable, this was the smallest advance since last autumn. A moderating of the rise in the index for nonfood commodities was largely traceable to declines in prices of new and used cars. Consumers, however, have been particularly conscious in recent months of rising food prices, and these prices have indeed shown little tendency to ease their rate of growth. The May advance, led by a further increase in the cost of beef, was at an annual rate of 5 percent, only slightly below the pace in March and April.

Another sharp rise in June in agricultural prices at the wholesale level clouds the prospects for near-term easing of the pressure on consumer food prices. The farm products index climbed at an annual rate of 9 percent in that month, and the index for processed foods and feeds advanced at a rate of 18 percent. On the strength of these increases, overall wholesale prices registered a 4¼ percent rate of gain. The index for the industrial commodities component, however, was unchanged after rising marginally for two months. This performance of industrial prices, as in April and May, apparently resulted from another drop in lumber and wood products prices. Steep declines since March in the quotations on several commonly used building materials—plywood prices, for example, are off as much as 50 percent from their peaks—presumably are associated with the weakening in the outlook for residential construction. In April and May, months for which full reports are available, the precipitous fall in timber products prices dampened the rise in the overall industrial commodities index. Excluding this component, the index in those two months advanced at an annual rate in excess of 3 percent, with substantial gains in the prices of metals, nonmetallic mineral products, machinery and equipment, and paper products.