The Business Situation

Business activity remains very strong although there are signs that capacity limitations are beginning to slow the advance. Industrial production rose further in May, but at a more moderate pace than that experienced earlier this year and in 1972. Inventory spending slowed in April; however, this slackening may have been largely unintended, as inventory-sales ratios remain inordinately low. The labor market displayed continued strength in June when the unemployment rate declined to 4.8 percent, the lowest level in more than three years. Retail sales increased in May but then declined in June.

The economy has faced a severe inflationary problem throughout 1973, with exceptionally rapid price increases at both the wholesale and retail levels. While some of these increases reflected a transitory price bulge, there are indications that the strength of demand has contributed substantially to the inflation. Many industries are reported to be operating at or near capacity, and there is evidence of serious delivery delays and shortages of more and more products and materials. On June 13, President Nixon imposed a freeze on virtually all prices, with the exception of prices of raw agricultural commodities sold at the farm level, for a maximum duration of sixty days. The latest price statistics, reflecting developments before the imposition of the price freeze, are very disturbing. Consumer prices increased in May at an annual rate in excess of 7 percent. Wholesale prices surged in that month and rose even more rapidly in June at a 31 percent rate, bringing wholesale price rises for the first half of the year to an extraordinary seasonally adjusted annual rate of 22 percent. While it will be some time before the impact of the freeze is evident in the price statistics, there are reports that serious distortions and increased shortages have already arisen in some industries. To avoid further distortions, it is desirable that the freeze end as quickly as possible. The Administration is in the process of devising a controls program more stringent than Phase Three to deal with inflation, but these measures have not yet been announced.

INDUSTRIAL PRODUCTION, CAPITAL SPENDING, ORDERS, AND INVENTORIES

Industrial production increased at a somewhat reduced pace in May. According to the Federal Reserve Board index, production climbed at a 5.9 percent seasonally adjusted annual rate in that month. This marked the smallest expansion in industrial output in ten months and came on the heels of a revised April hike of about 8 percent. Over the first five months of the year, industrial production has risen at an 8.5 percent pace by comparison with an increase in excess of 10 percent over 1972 as a whole. This recent slowing notwithstanding, production has now advanced steadily on a month-by-month basis since October 1971. The last time output increased consistently over such an extended period was the interval from November 1964 through October 1966 (see Chart I).

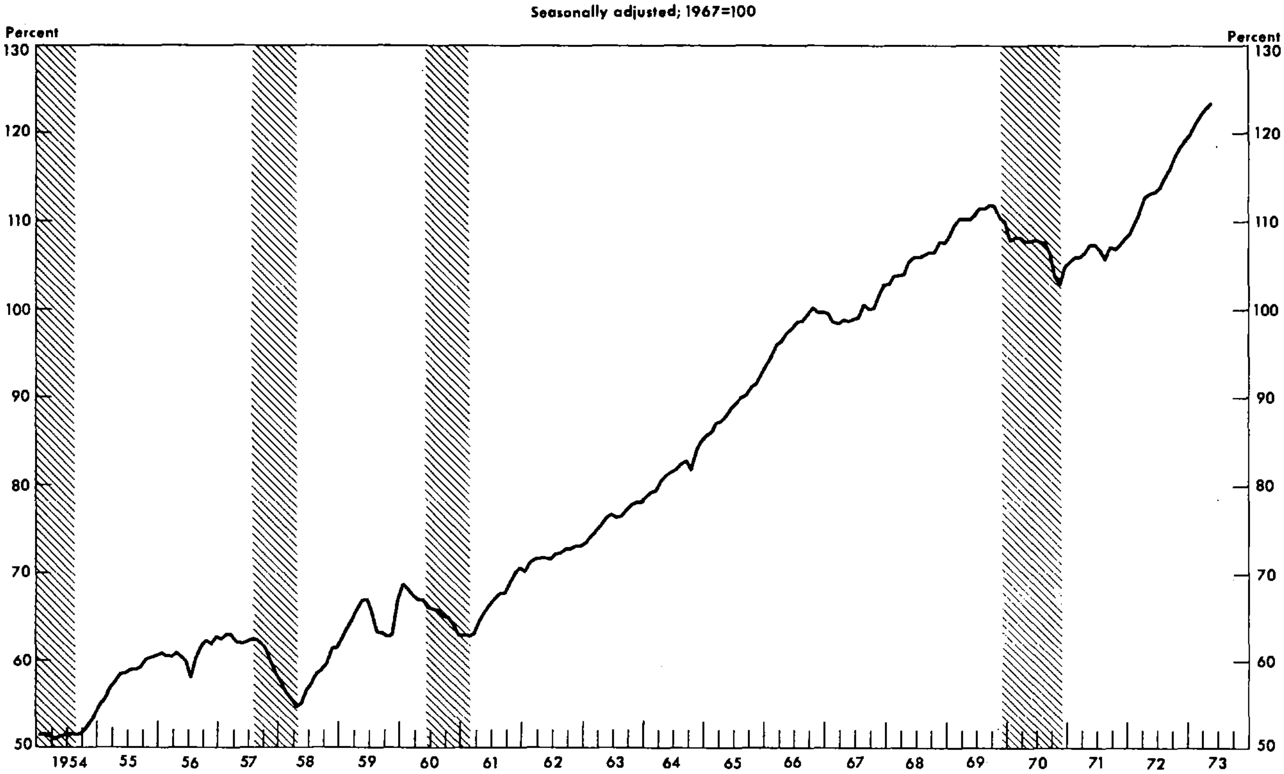
Output of business equipment and consumer goods increased considerably in May. Production of business equipment climbed at a 12.3 percent annual rate following an even more rapid expansion in April. Over the first five months of 1973, business equipment output has risen at an annual rate of 16.2 percent, well above the 13.4 percent rate of advance posted in 1972. Production of consumer goods increased at an 8.3 percent rate in May after a very small gain in the previous month. On the other hand, output of industrial materials grew at a much slower annual rate of 2.8 percent. However, this slowing may be a reflection of capacity limitations in some industries which have precluded firms from expanding output to meet demand. Output of defense and space equipment fell off again in May after spurting in April.

According to the Commerce Department's most recent estimates, businesses increased their expenditures on plant and equipment by $4.3 billion in the first quarter to a seasonally adjusted annual rate of $96.2 billion. This gain was about equal to that registered in the fourth quarter of 1972. For 1973 as a whole, the latest Commerce survey indicates a rise in outlays for plant and equipment of 13.2 percent, slightly less than the increase recorded in their previous survey. Nevertheless, if realized, this would be the largest expansion in capital spending since 1966. Manufacturers' outlays for plant and equipment are anticipated to increase 18.5 percent over the year, up sharply from the 4.5 percent rise posted last year. Spending by nonmanufacturing firms is projected to advance 10.3 percent, down slightly from the 11.5 percent gain in 1972.

Orders placed with manufacturers of durable goods rose $0.9 billion, or 2.2 percent in May. This gain constitutes some resurgence in orders following an April increase of less than 1 percent. Nevertheless, the past two months represent, on balance, a slowdown in new bookings relative to the extraordinarily rapid advances earlier in the year. (It should be noted that the data for new orders have recently been revised to reflect bench-mark and seasonal factor changes.) About one third of the May increase in orders was attributable to a large rise in bookings for primary metals. Bookings for capital goods industries increased in the month despite a decline in defense orders. The backlog of unfilled orders continued to rise strongly during May as it has for many months. Some of the buildup in the backlog may reflect overbooking, however, as delivery times have lengthened and some products and materials have come into short supply.

In April, the book value of total business inventories increased $1.2 billion following gains which averaged more than $1.8 billion per month over the first quarter of the year. The April inventory accumulation was the smallest since December. Moreover, it is doubtful whether this advance represents much, if any, increase in the physical volume of stocks, since it probably largely stems from sharply higher prices for replacement goods put into stock.

Chart I
INDUSTRIAL PRODUCTION
Seasonally adjusted; 1967=100



Note: Shaded areas represent recession periods, according to the National Bureau of Economic Research chronology. The dates of the 1969-70 recession are tentative.
Source: Board of Governors of the Federal Reserve System.

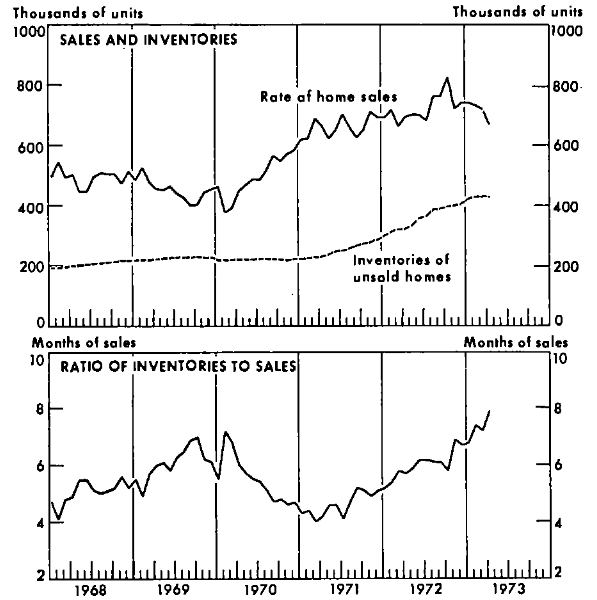
In any event, the book value of manufacturers' inventories rose modestly in April, as did retail and wholesale stocks. The ratio of inventories to sales for all businesses remained at a low level, still suggesting that a substantial buildup in inventories may be in the offing.

Preliminary data indicate that the book value of manufacturers' inventories rose $0.9 billion on a seasonally adjusted basis in May. Much of this increase in inventory spending was in durable goods industries. Durable shipments moved ahead by $0.5 billion in May, but nondurables shipments dropped off slightly. The overall inventory-sales ratio for manufacturing was virtually unchanged in May.

Chart II

SALES AND INVENTORIES OF SINGLE-FAMILY HOMES

Seasonally adjusted



Note: New-home sales are expressed as an annual rate; the inventory of unsold homes is the stock at the end of the month.

Source: United States Department of Commerce, Bureau of the Census.

RESIDENTIAL CONSTRUCTION, RETAIL SALES, CONSUMER CREDIT, AND PERSONAL INCOME

Housing starts rebounded in May after declining for three consecutive months. The increase, to 2.4 million units at a seasonally adjusted annual rate, reflected a small gain in starts of single-family units and a substantial jump in multifamily starts. Newly issued building permits edged up in May as well, although, except for April, they were at their lowest level since early 1971.

Notwithstanding these May increases, there are signs of overbuilding in housing which suggest a further diminution in activity in the months ahead. While inventories of new unsold one-family homes were virtually unchanged in April (the latest data available), the number of unsold units remained well above levels posted in 1972 (see Chart II). Meantime, sales of new one-family homes dropped sharply to a seasonally adjusted annual rate of 667,000 units in April. This represented the lowest sales rate in over one year. Because of the sharp decline in sales, inventories of unsold new homes reached 7.9 months of sales, the highest level since the series began in January 1963. Over the first four months of 1973, the inventory-sales ratio for new homes averaged 7⅓ months, considerably above the already high average of 6 months posted in 1972. The April decline in mobile home shipments may also be an indication of the expected slowdown in housing over the final months of 1973.

Recent data provide evidence of some moderation in the growth rate of consumer spending. Of course, seasonally adjusted retail sales had grown at a very rapid 26 percent annual rate over the first three months of the year, and this pace was clearly unsustainable. After declining in April, retail sales rose in the next month but then fell again in June to $41.3 billion. Sales in each month of the second quarter remained below their March peak. For the most part, the slowdown in consumer spending has been concentrated in durable goods, particularly automotive products. In June, unit sales of new domestic-type automobiles moderated from their rapid May pace to a 9.1 million unit seasonally adjusted annual rate. During the first six months of 1973, sales of domestically produced automobiles averaged 10 million units. Sales of imported cars were at an annual rate of 1.8 million units in June, compared with 1.9 million units in both April and May.

Another hefty advance was recorded in consumer credit in May, when the stock of total consumer debt outstanding rose $2.2 billion on a seasonally adjusted basis. By comparison, total consumer credit had increased $1.7 billion in April and on average $2.1 billion over the first three months of the year. In recent months, the apparent leveling-off in the rate of growth of total credit reflected the noticeable pickup in the rate of repayments of instalment debt, which may in turn have been related to the unusually large Federal income tax refunds.

Personal income rose by a relatively modest $4.8 billion in May to $1,012 billion at a seasonally adjusted annual rate. Over the first five months of the year, personal income has climbed an average of $5.9 billion per month.

In May, a gain in wage and salary disbursements of $3.1 billion accounted for much of the rise, with the remainder of the increase resulting primarily from gains in interest income and in transfer payments.

LABOR MARKET DEVELOPMENTS

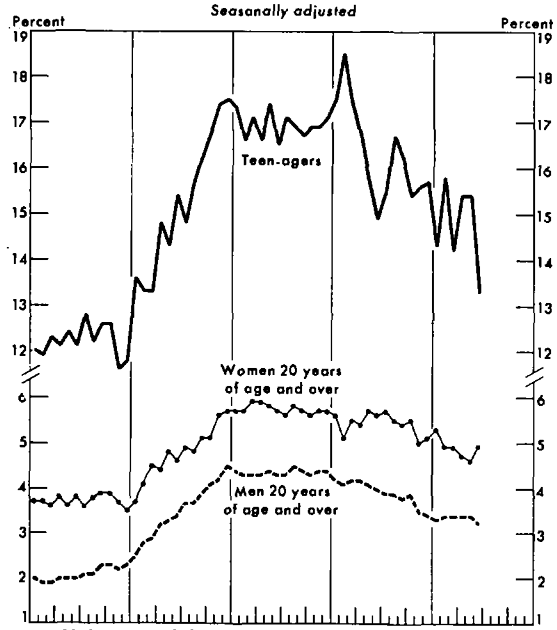
There are clear indications of continued strength in the labor market. According to the survey of households conducted by the Department of Labor, civilian employment increased sharply in June, after rising modestly in the two preceding months, and the overall rate of unemployment dropped to a seasonally adjusted 4.8 percent, the lowest it has been in more than three years. Data on the unemployment rates of major age-sex groups indicate that the unemployment rate for adult men edged down to 3.2 percent in June, while the more volatile teen-age unemployment rate fell dramatically (see Chart III). On the other hand, the unemployment rate for adult women rebounded to the level prevailing in February and March of this year.

Payroll employment rose by about 200,000 workers in June, a somewhat smaller gain than those recorded on average in earlier months of the year. Nevertheless, the 4 percent annual rate of growth in payroll employment during the first half of 1973 is slightly above the pace of expansion of the previous year, and it may well be that the strength of the labor market is greater than this comparison suggests. The data on labor turnover rates in the manufacturing sector of the economy provide support for this view. The rate at which workers are newly hired climbed to 4.3 per 100 employees in May, the highest level since early 1966. Throughout the first five months of the year, the new hire rate was running more than 23 percent above the average for 1972. At the same time, there was a marked expansion in job vacancies. Over the first five months of 1973, the increase in seasonally adjusted job vacancies amounted to almost 40 percent at an annual rate.

Chart III

SELECTED UNEMPLOYMENT RATES

Seasonally adjusted



Source: United States Department of Labor, Bureau of Labor Statistics.

PRICES AND WAGES

The economy has faced a severe inflationary problem throughout 1973. Wholesale prices soared at a 20.5 percent seasonally adjusted annual rate over the first five months of the year, while consumer prices advanced at a very disturbing 8.2 percent rate. To be sure, some of these increases doubtless reflected a transitory price bulge, following the introduction in January of the largely voluntary Phase Three of the controls program. Moreover, a bunching of price increases probably resulted as some firms raised prices in anticipation of the adoption of more stringent controls. Nevertheless, there are also indications that the recent strength of demand has contributed measurably to the inflation. Many industries are reported to be operating at or near capacity, and there is evidence of serious delivery delays and shortages of more and more products and materials.

In this environment, President Nixon announced on June 13 a freeze on virtually all prices, with the exception of prices of raw agricultural commodities sold at the farm level, for a maximum duration of sixty days. The Administration intends to use this period to devise a controls program to replace Phase Three. During the freeze, prices are limited to their highest levels reached between June 1 and June 8. Wages and interest rates were not frozen but remain subject to Phase Three guidelines; in another development, the Committee on Interest and Dividends recently liberalized the rules regarding corporate dividend payments.

The impact of the freeze will not be evident in the price statistics until the July data are released sometime in August. The latest data, covering developments before the imposition of the freeze, present a very distressing picture. In June, wholesale prices rose at a disastrous 31.2 percent seasonally adjusted annual rate. Wholesale prices of industrial commodities alone climbed at a 12.4 percent rate, about the same rate of advance as that experienced over the preceding five months. Meanwhile, wholesale prices of farm products and processed foods and feeds renewed their unprecedented advance in May and then surged upward at a seasonally adjusted annual rate in excess of 79 percent in June. These last months have pushed wholesale agricultural prices up at an almost unbelievable 47.5 percent annual rate over the first six months of the year.

Consumer prices continued to spiral upward in May, advancing at a 7.3 percent seasonally adjusted annual rate. Price increases at the consumer level have slowed somewhat over the past few months, leaving the May gain more than 1 percentage point under the rate of increase posted over the first four months of the year. By other standards, of course, this advance is still very rapid. For example, consumer prices rose 3.4 percent over 1972. The May advance in food prices, at a 14 percent seasonally adjusted annual rate, is substantially below the 26 percent rate of increase registered during the first four months of 1973. Nevertheless, it is almost three times as great as the increase in food prices in 1972. Nonfood commodity prices, climbing at a 5 percent seasonally adjusted annual rate in May, showed little change from their pace of the previous three months. Higher prices for apparel, used cars, and gasoline accounted for most of the May rise. Prices of consumer services, which are not seasonally adjusted, advanced at a 4.5 percent annual rate in May.

Recent hikes in wage rates have continued to be fairly moderate. In June, the average hourly earnings of workers in the private nonfarm sector rose at a 6 percent seasonally adjusted annual rate. Adjusted for overtime hours in the manufacturing sector and for shifts in the composition of employment among industries, the rise in average hourly earnings was a more rapid 7.7 percent. So far this year, however, the pattern of monthly advances in hourly earnings has been rather erratic, perhaps because the timing of pay raises has been affected by the controls program. As a result, it may be preferable to examine the growth in wage rates over periods of several months. Over the five months ended in June, adjusted average hourly earnings of workers in the private nonfarm economy have increased at a 5.8 percent annual rate, the same rate as that experienced during the preceding twelve-month period.