The Business Situation

While many business indicators have lately been distorted by the rocketing rate of inflation, it appears that a modest recovery in economic activity is under way. Industrial production advanced in May for the second consecutive month, following the sharp energy-related declines in the four preceding months. At the same time, new orders for durable manufactured goods rose, and the backlog of unfilled durables orders climbed further. An expansion in capital spending appears to be in prospect for coming months, especially in the manufacturing sector. On the other hand, consumer spending has remained noticeably weak. Constant-dollar retail sales have been essentially flat throughout the year, well below the peak level attained early in 1973. Residential construction has been plagued by higher interest rates, increasing costs and prices, declining new home sales, and a general unavailability of mortgage financing. Although the unemployment rate rose in May, it was largely the result of a large jump in the teen-age labor force following two months of unusual declines. In June, labor market conditions were essentially unchanged and the unemployment rate held steady at 5.2 percent of the civilian labor force.

Inflation remains severe in most sectors of the economy. At an annual rate, consumer nonfood prices spurted 15 percent in May, up slightly more than 3 percentage points from the rate of increase experienced in earlier months of the year. Also in May, a sharp acceleration occurred in the rate of advance of wholesale industrial prices, excluding power and fuel. In contrast, wholesale agricultural prices dropped for the third consecutive month. To the extent that some of these increases reflect the termination of price controls, the pace of inflation should moderate in coming months. However, the degree of moderation is likely to be limited as a result of the concurrent buildup of cost pressures on prices. While there are indications that at least some raw materials prices are receding from recent peaks, it is too early to conclude what effect this might have on finished product prices. Furthermore, the failure of declines in food prices at the wholesale level to affect retail food prices significantly is a matter of concern.

INDUSTRIAL PRODUCTION, ORDERS, AND INVENTORIES

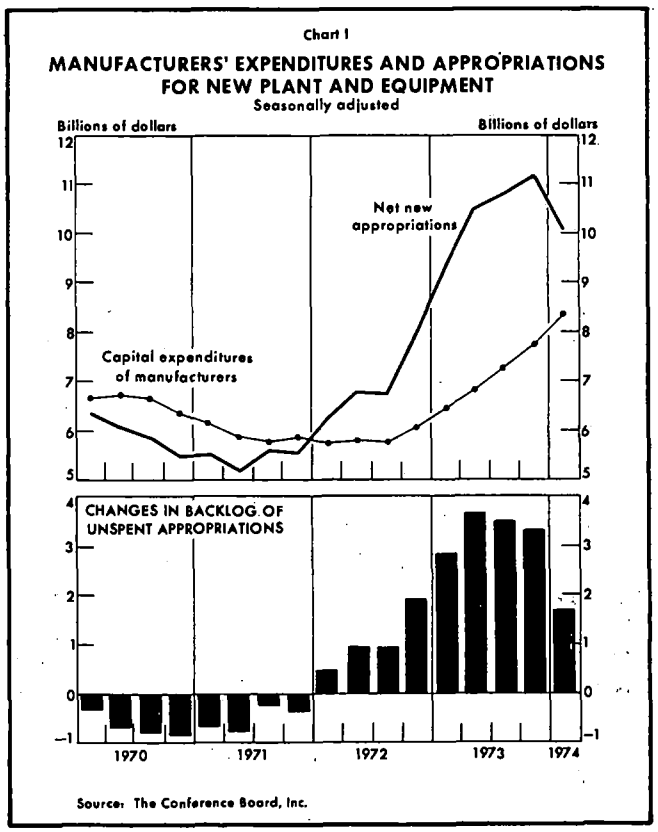
On a seasonally adjusted basis, the Federal Reserve Board's index of industrial production rose in May at a 4.8 percent annual rate, its second consecutive monthly advance. Nevertheless, the index in May remained 1.6 percent below last November's peak. The overall May advance was concentrated in the output of consumer goods and business equipment. Total energy production increased in May, and gasoline output surpassed its pre-embargo level. The production of basic materials was unchanged. However, there appears to have been some easing lately in the very tight supply conditions that had prevailed in many basic raw materials industries through much of last year. The Federal Reserve Board's index of capacity utilization in major materials industries has declined for two successive quarters following the record high level reached in the third quarter of 1973. Moreover, according to the National Association of Purchasing Management's survey, the percentage of respondents reporting forward commitments of sixty days or longer to buy production materials has declined noticeably since February. Despite the easing, some materials are still in short supply.

The automotive sector has displayed signs of a modest further recovery in recent months. In May, new car assemblies rose to a seasonally adjusted annual rate of 7.7 million units, the highest thus far this year but nearly 25 percent below the pace of a year ago. Sales of new domestic models increased slightly in June to an annual rate of 8 million units, up about 5 percent from the rate of sales averaged in the first quarter of the year. Increased sales of full-size models accounted for virtually all of the

improved performance of the past several months, as the market share of small models declined to about one third of total sales.

Led by the large advance in new bookings for primary metals, the seasonally adjusted flow of new orders placed with durable goods manufacturers surged 5.9 percent in May. Coupled with the large increase of the preceding month, the May rise advanced new durables orders above the high level that had prevailed late last year. The April and May gains, moreover, exceeded the price hikes recorded for manufactured durable goods in those months. Shipments of durables also rose in May, but they remained below new orders, and the backlog of unfilled orders mounted further. While in recent months the accelerating rate of inflation has boosted the growth rate in the backlog of unfilled orders, an uptrend is still in evidence when unfilled orders are measured in constant-dollar terms.

The book value of manufacturing inventories rose significantly in May, advancing at a seasonally adjusted annual rate of close to $28 billion. This represents a substantial increase over the gain of the previous month and is somewhat more than the $25.6 billion increase averaged in the December-to-February period. However, since manufacturers' shipments have kept pace, the inventory-sales ratio in this sector has remained virtually unchanged at 1.62 for four consecutive months. As a consequence of inflation, the inventory figures are somewhat difficult to interpret. It does not appear, however, that a substantial amount of undesired inventory accumulation has been camouflaged because of price movements. Less than 15 percent of the May rise in manufacturing inventories was attributable to increased stocks of finished goods. The remainder was the result of increases in stocks of purchased materials and work in progress. Apart from the buildup of purchased materials and work in progress in capital goods industries, which reflect the continued expansion in new bookings, the buildup of nonfinished goods inventories over the last several months may be a consequence of the shortages which depleted buffer materials stocks during 1973. In the aftermath, firms were induced to accumulate material inventories.



CAPITAL SPENDING

According to the survey taken by the Commerce Department in April and May, total business outlays for new plant and equipment are now expected to rise 12.2 percent in nominal terms in 1974, only slightly below the 13 percent gain foreseen in the Commerce Department's survey taken three months earlier. The downward revision was in expenditure plans for the second half of the year and was centered in nonmanufacturing industries, particularly electric and gas utilities, mining, and communications. In contrast, for manufacturing industries, the planned 19.8 percent increase for 1974 outlays on new plant and equipment is slightly higher than the figure reported three months earlier. Moreover, within the manufacturing sector, major material-producing industries reported relatively large increases in intended outlays, much of which will go toward expanding current capacity.

In a separate survey conducted earlier by the Conference Board, net new appropriations for capital goods by the nation's 1,000 largest manufacturing firms declined almost 10 percent in the first quarter on a seasonally adjusted basis (see Chart I). Most of this decrease was attributed to an extraordinarily large increase in project cancellations by the automotive industry, which was then enshrouded by the uncertainties of the energy shortage; it was anticipated that many of these canceled projects would be reinstated in subsequent quarters. In any event, the backlog of unspent appropriations swelled further, rising by 4.6 percent over the quarter. At a record $38.3

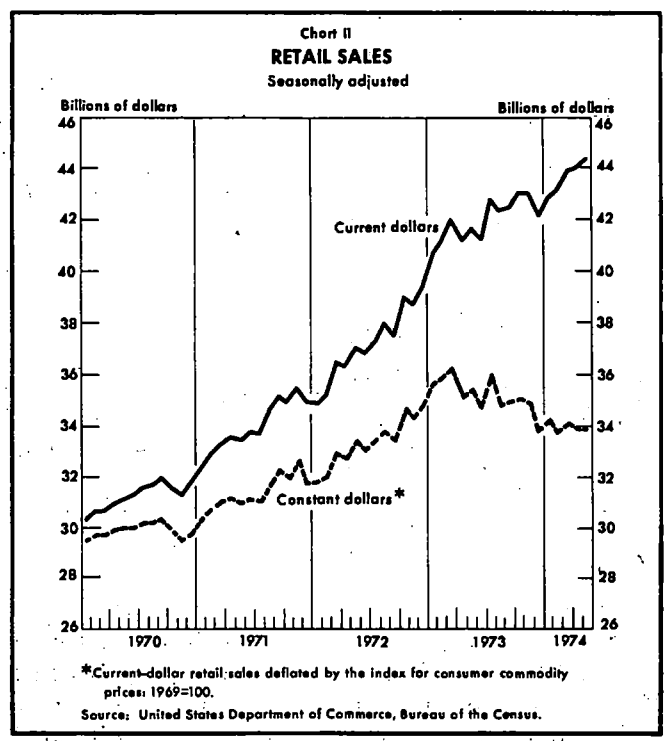
billion in the first quarter, unspent appropriations were almost 50 percent higher than a year earlier. Judging by past experience, most of these unspent funds will be translated into actual expenditures, and this augurs for a sizable increase in capital expenditures by manufacturers over the near term.

PERSONAL INCOME AND CONSUMER DEMAND

While the expansion in personal income picked up over the April-May period, constant-dollar retail sales remained weak. Personal income advanced at a $10.6 billion seasonally adjusted annual rate in May, the biggest rise since last November. Farm income fell for the fifth consecutive month as agricultural prices continued to decline. This was more than offset by the large $7.8 billion gain in wage and salary disbursements in the private sector, of which about $2 billion stemmed from the expanded coverage and higher minimum wage rate of the newly instituted minimum wage law. Increases in manufacturing employment and an acceleration in average hourly earnings boosted wage and salary disbursements in manufacturing by $3.1 billion, the largest hike in over two years.

In May, seasonally adjusted retail sales rose $425 million, an 11.6 percent annual rate gain. Sales of both automotive and other durable goods were up noticeably in current-dollar terms, while nondurables sales inched ahead. Over the first five months of the year, retail sales of nonautomotive durable goods climbed at almost a 20 percent annual rate, while gains in the automotive and nondurables categories were more moderate. Although automotive retail sales, which include purchases of both new and used cars, have rebounded from the February low, in May they were still 7 percent below last year's average monthly sales.

When the retail sales figures are adjusted for recent price hikes, consumer spending appears to have been decidedly weak of late (see Chart II). Indeed, measured in terms of the consumer commodity prices that prevailed in 1969, constant-dollar retail sales not only declined in May but were lower than at the start of the year. This decline, moreover, has been widely based, encompassing automotive, other durables, and nondurables purchases. Over the past year and a half, there has also occurred a relatively large drop in real income, although the extent of the decrease is difficult to measure. In any event, it seems clear that the erosion in real income has had a deleterious impact on the rate of real consumer spending.

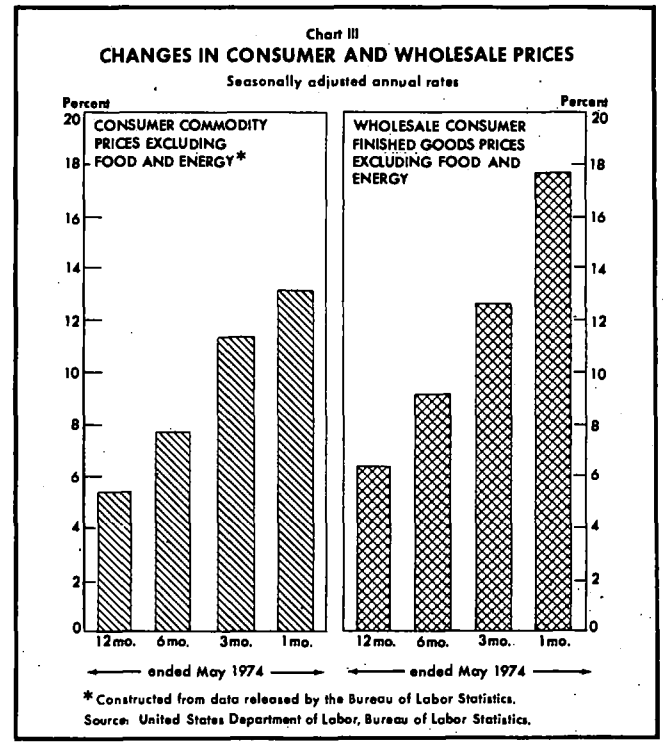


RESIDENTIAL CONSTRUCTION

Reflecting very tight mortgage market conditions, the residential housing situation continued to deteriorate in May. Private housing starts dropped precipitously, falling 11 percent to a seasonally adjusted annual rate of 1.45 million units. New building permits also fell almost 19 percent to 1.06 million units, the lowest total since April 1967. Continuing the pattern which emerged late last year, the May decline in housing starts was largely attributable to the steep drop in new construction of multifamily units. In recent years, real estate investment trusts have emerged as important lenders for multifamily unit construction. No doubt the difficulties they have had of late in issuing stock and tapping other sources of funds has contributed to the scarcity of financing for multifamily units.

The run-up in interest rates during the last several months has severely restricted the availability of mortgage money. Seasonally adjusted deposit growth of thrift institutions slowed to 1 percent at an annual rate in May, in contrast to the 7.3 percent growth rate during the first four months of the year. At the Federal National Mortgage Association's auction on July 2, the secondary market interest rates on four-month forward commitments for insured and conventional mortgages were in excess of 9.6 percent. The Federal Home Loan Bank Board's effective interest

rate on new home conventional mortgages climbed to a new record in May. For potential home buyers, the cost of mortgage financing has risen further. Reportedly, commitments on conventional mortgages are now being negotiated at contract rates slightly in excess of 9 percent.



LABOR MARKET

According to the household survey, the civilian labor force grew by 366,000 persons in May. This was more than enough to offset the largest gain in total civilian employment of the past six months. Consequently, the overall unemployment rate went up 0.2 percentage point in May to 5.2 percent on a seasonally adjusted basis. The May increase in the number of jobless workers looking for employment was more than accounted for by the additional 199,000 teen-agers who were unemployed. Labor market conditions were little changed in June, as the unemployment rate held steady and the age-sex composition of unemployment remained essentially unaltered. Total civilian employment increased by 194,000 workers in June, matching the May gain.

Some peculiarities in the household survey seem to have reversed themselves in the May data. It had been expected that an economic slowdown would result in higher joblessness particularly among secondary workers, most of whom are women and teen-agers. These expectations were not borne out by the data for earlier months. However, in May, both the teen-age and adult female unemployment rates rose from their low April levels, while the adult male unemployment rate fell to 3.4 percent. In addition, the adult male civilian labor force increased by a substantial 162,000 workers, reversing the declines that had occurred in the two previous months.

Seasonally adjusted payroll employment rose by a healthy 214,000 in May but subsequently declined by about 50,000 workers in June. The May rise was largely the result of big gains in government and services employment. To some extent, increased strike activity in contract construction may have contributed to the June decline in payroll employment. While the results of the household and payroll surveys diverged considerably in June, this frequently occurs because of differences in coverage, sampling techniques, and seasonal patterns. The surveys tend to show comparable changes over somewhat longer periods of time.

Taking a somewhat broader perspective, it is noteworthy that neither the unemployment rate nor the growth rate of employment since last November has been as severely affected by the recent economic slowdown as during the first six months of the 1960-61 and 1969-70 recessions. Much of the first-quarter decline in real output was centered in the automotive sector, where labor productivity is relatively high. Consequently, with so many automotive workers laid off in the early months of the year, a small increase in unemployment was accompanied by a large decline in real output. Moreover, to the extent that the slowdown was the result of materials shortages rather than slack demand, employers were probably more reluctant to lay off workers than they would otherwise have been.

The latest wage data point toward an acceleration in the rate of growth of hourly earnings. On a seasonally adjusted basis, average hourly earnings of production and nonsupervisory workers in the private nonfarm economy, adjusted for overtime hours in manufacturing and for shifts in the composition of employment among industries, increased in June at a 12.3 percent annual rate. This was equal to the May advance but was well above the rate of increase in earnings experienced over the preceding six months. Especially large increases in hourly earnings were recorded in June for workers in the manufacturing, finance, and construction sectors. In part, these hikes doubtless reflected the termination of wage controls. In the months ahead, the increases in contract settlements and in hourly

wage rates are likely to remain substantial, as workers attempt to keep pace with the rate of inflation as well as to make up for previous declines in real earnings over the past year or so.

PRICES

Inflation remains severe in most sectors of the economy, though lately there has been some retrenchment in food prices at the wholesale level. In line with previous expectations, the rates of increase in consumer and wholesale nonfood prices both accelerated in May, reflecting in part the price hikes that many firms instituted when the price controls program was terminated on May 1.

Consumer prices, seasonally adjusted, resumed their explosive advance in May, surging ahead at a 12.7 percent annual rate. A disturbing feature of the May increase was its pervasiveness. Consumer food prices posted a fairly large rise, more than erasing the previous month's drop. Consumer nonfood commodity prices jumped 15.3 percent in May, almost double the rate of advance of the previous twelve months. The recent acceleration in these prices is undoubtedly the result of the concurrent run-up in wholesale consumer finished goods prices (see Chart III).

At the wholesale level, prices rose at a 15.5 percent seasonally adjusted annual rate in May. Higher industrial wholesale prices wholly accounted for the overall advance, as the prices of farm products and of processed foods and feed posted another sharp decline. Wholesale power and fuel prices decelerated further in May, though their rate of increase still topped 30 percent. Excluding power and fuel prices, industrial prices surged at a 32.5 percent annual rate in May, up from the 25 percent rate recorded during the previous three months. The May spurt reflected both the response of firms to the removal of the price controls and the pass-through of current and previous increases in energy and materials prices. In May, prices of nonfood raw materials declined sharply, the first decrease in two years, but prices of intermediate nonfood materials and supplies jumped considerably.