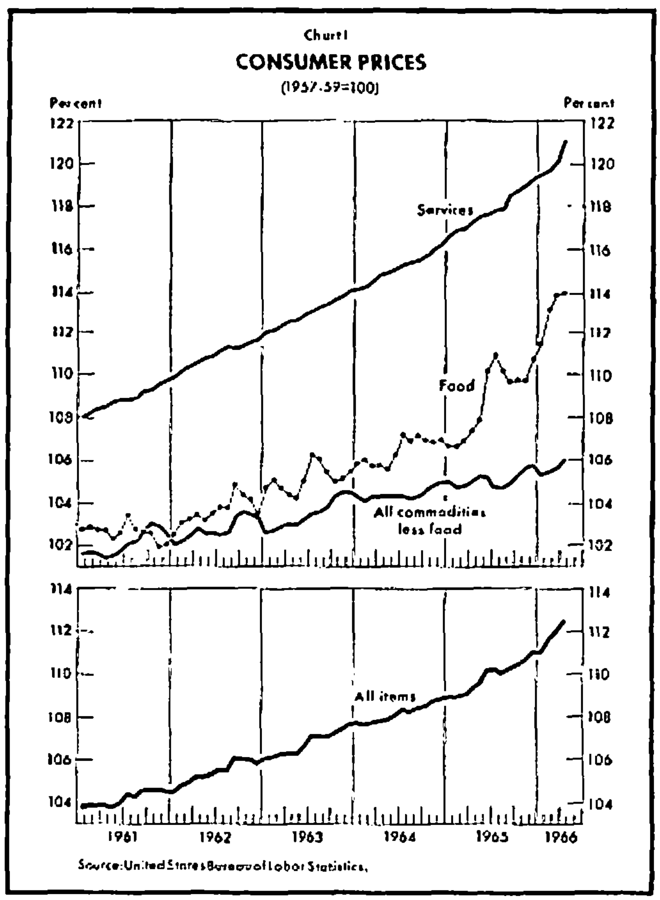
The Business Situation

The rate of growth of domestic business activity has moderated somewhat, following an extraordinary surge of activity in the first three months of the year. In view of the fact that the first-quarter rate of economic growth had inflationary implications and was quite clearly unsustainable, the slower pace of recent weeks is an encouraging development both for the near-term and the longer term outlook. Indicators of prospective demand in the months ahead continue to point to further advances in output and spending. Despite the recent slackening of economic growth—and the May rise in unemployment, mainly among teen-agers—the likelihood of continued pressure on industrial capacity, the supply of skilled labor, and prices remains.

The slower pace of the business expansion in April showed up in a reduced rate of advance in overall industrial production and personal income. In addition, retail sales and new orders received by manufacturers of durable goods backed off a bit from their high March levels. Strikes and poor weather conditions appear to have been a factor in some of these developments, but reduced rates of production and sales in the automobile industry were clearly an important dampening influence. To what extent consumer demand for new cars may have been affected by recent public discussion of vehicle safety and by higher excise taxes on autos is not clear. In any case, a survey of consumer buying intentions taken in April found that plans to purchase automobiles remained at about the high level of the previous April. Moreover, intentions to purchase other consumer durables moved up strongly, indicating that any slack in automobile sales may be offset by spending on other durables. Indeed the outlook for further strength of overall consumer demand and of other broad areas of demand, such as capital spending, point up the danger of reading too much into the slowdowns apparent in some recent data—especially in view of the normally erratic course of short-term movements in many sectors of the economy.

Prices of goods and services have continued to move up (see Chart I). In April, the consumer price index advanced by 0.5 percentage point, exceeding the average monthly increase of 0.3 percentage point experienced in the first quarter and bringing the annual rate of increase so far this year to a very high 4.1 per cent. One special factor pushing up consumer prices in April was the restoration of excise taxes on new automobiles and telephone services effective March 15 and April 1, respectively, thereby offsetting the excise reductions made on these items at the beginning of the year. Price increases were reported in all major classifications of consumer purchases, however, with services replacing foods as the primary cause of the advance in the overall index. At the whole-



sale level, prices were about unchanged on average in April as declines in farm and food prices largely offset a substantial 3.5 per cent annual rate increase for industrial commodities. So far this year, industrial wholesale prices have risen at an annual rate of 3.2 per cent as against 1.4 per cent in all of 1965.

OUTPUT, ORDERS, AND INVENTORIES

Total industrial output rose to a record level in April, but the gain was much reduced from the average advance for the preceding three months. The Federal Reserve Board's seasonally adjusted index of industrial production increased by just under 0.3 per cent for the month, compared with the large average monthly gains of 0.9 per cent in the first quarter of the year. The brief railroad strike in early April and the coal mining strike that month had a substantial dampening impact. The reduction in automobile output was also a minor factor.

The recent weaker tone in the automobile industry followed an extraordinary performance earlier in the year. In 1965, sales of domestic cars amounted to 8.8 million, and most observers foresaw little likelihood of significantly higher sales in 1966. Nevertheless, in the first quarter of the year, sales were running at a seasonally adjusted annual rate of 9.3 million. In April, sales began to back off from this high level, amounting to a seasonally adjusted annual rate of about 7.9 million for the month, and with inventories rising, cutbacks in production schedules soon followed. Auto sales in May decreased further to a seasonally adjusted annual rate of 7.3 million units, and production also continued to move down. That there has been some decline from a first-quarter sales rate which many observers regarded as unsustainable is perhaps not surprising. Industry spokesmen have stated their belief that public airing of the safety issue was a factor in the timing of the slowdown. The repeal on March 15 of the portion of the excise tax cut on automobiles that had become effective at the beginning of the year may also have played a role. While the actual dollar impact of the increase in the tax was small—perhaps amounting to little more than \$20 on the average new car—dealer promotions apparently made much of this imminent increase in costs. Moreover, price-conscious business and Government purchasers may also have bunched some purchases in the January through mid-March period that would otherwise have been delayed until spring.

Despite the dampening influence of reduced steel orders from automobile manufacturers, iron and steel output advanced to a record annual rate of roughly 140 million tons in April, and it appears that steel production remained at roughly the same high level in May. The demand for some steel products is advancing quite rapidly, and industry spokesmen have stated that it will be difficult to maintain current prices in the months ahead.

There was another notable expansion in the output of defense goods in April, and new orders in that sector remained strong. Reflecting the strength of capital spending, production of business equipment moved further ahead as sizable gains were reported throughout the machinery and transportation equipment industries except for the motor vehicles and parts category. With delivery times lengthening in many industrial areas, purchasers have turned increasingly to foreign producers, and imports, particularly of business equipment, rose substantially during April. Output of consumer goods also continued to advance beyond the high first-quarter level despite the dampening influence of slower automobile production. Solid gains were posted in the production of color TV sets and other home appliances, furniture, and a wide range of nondurable goods.

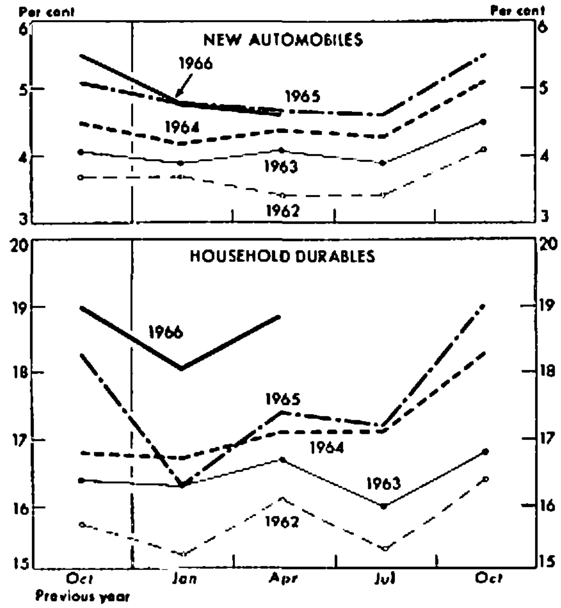
Prospects for further production gains in the months ahead appear good. New orders received by manufacturers of durable goods have increased by progressively larger amounts in each of the past five quarterly periods. And although new durables orders in April moderated somewhat from the March level, they remained at the high monthly average of the first quarter. As new orders continued to exceed shipments, unfilled orders climbed to new highs. Including nondurables orders, backlogs have now topped \$70 billion, a solid \$12 billion advance in the past year. Rising backlogs are being experienced by manufacturers of primary metals, fabricated metal products, machinery and business equipment, transportation equipment, and other durable goods. The present backlog of unfilled orders is equivalent to about three months of shipments at the current rate.

Advancing levels of unfilled orders combined with the high rates of capacity utilization place increased pressure on producers to continue adding to their equipment and facilities. In most instances, these pressures seem to be outweighing the restraining effects of higher interest costs and reduced availability of credit as well as higher capital goods prices and slower deliveries. Indeed, according to a Commerce Department and Securities and Exchange Commission survey taken in May, businessmen's plans to expand capital expenditures in 1966 appear to have increased a moderate 1 percentage point from the 16 per cent rise indicated in the February survey. Some announced cutbacks in planned projects have been offset by upward revisions, and in addition higher than previously anticipated costs for construction and equipment are likely to offset the cutbacks in terms of total dollar spending.

Conservative inventory-sales ratios, and recent reports that inventory buildups in many industries are falling short of plans, also support the outlook for further production increases. Inventory-to-shipment ratios among manufacturers are now significantly below the high of the current business expansion, while inventory-to-sales ratios among retailers of both durable and nondurable goods are averaging moderately less than levels for a year ago.

Chart II

CONSUMER INTENTIONS TO BUY NEW AUTOMOBILES AND HOUSEHOLD DURABLES WITHIN SIX MONTHS



Note: Buying plans are expressed as the ratio of the number of families who indicate they intend to buy to the total number of families in the survey.

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

EMPLOYMENT, INCOME, AND CONSUMER DEMAND

Partly reflecting the more moderate pace of economic activity, nonagricultural employment remained stable in April though it moved up moderately in May. In April, strikes and unfavorable weather conditions resulted in employment decreases in the mining and construction industries, while declines were also reported in the retail trades, perhaps because of the fact that the monthly employment survey followed the Easter holiday this year. These reductions offset job gains in manufacturing, government, and other nonagricultural jobs. In May, advances in nonagricultural employment were recorded in all major industrial categories except construction and finance. The seasonally adjusted rate of unemployment moved up to 4.0 per cent in mid-May, however, from 3.7 per cent the month before. The Bureau of Labor Statistics, which collects and processes the data, attributed the May increase to a larger than usual number of students looking for work while still in school and a slightly larger than usual number of women entering the labor force. Normally, many women are needed to work on farms in May but, due to poor weather conditions, employment in agriculture was lower than usual for the month. Attesting to the continued underlying firmness in the labor market, the unemployment rate for married men—the hard core of the civilian labor force—remained at its low April level of 1.8 per cent.

Stability in nonagricultural employment in April and the reduced rate of income expansion in the same month may well have been among the factors contributing to the moderate decline in retail sales. After climbing to three consecutive all-time highs during the first quarter of this year, sales volume at retail outlets was down about 1 per cent for the month. The level, however, remained fully 10 per cent above the year-ago figure. The April decrease was more than accounted for by lower automobile sales. In addition, unfavorable weather in many areas of the country adversely influenced sales of lumber, building materials, and hardware. It is striking, however, that retail sales excluding automobiles rose to $20.7 billion, roughly 2 per cent above the exceptionally strong monthly average in the first quarter of the year. Gains among a wide range of nondurable goods continued strong.

Prospects for consumer demand over the months ahead are bright, according to the Census Bureau's latest quarterly survey of consumers' buying intentions taken during the third full week of April. This survey indicated a marked increase in the proportion of families reporting that their incomes had advanced during the previous twelve months, and the percentage expecting still higher incomes in the year ahead also showed a gain. Consumers' intentions to buy new automobiles during the next six months moved down moderately to a level roughly in line with the figure reported for the corresponding period a year ago (see Chart II). The proportion of families planning to buy at least one of the seven household durable goods included in the survey was 18.8 per cent, significantly above the year-earlier reading of 17.4 per cent (also shown on Chart II).