The Business Situation

The growth of economic activity moderated in April, in part owing to the disorders that followed the murder of Dr. Martin Luther King, Jr. More recently, the pace of expansion appears to have accelerated again, and it is likely that the second-quarter rise in aggregate demand will at least equal the first quarter's sharp gain. Industrial production was unchanged in April, but probably increased in May when automobile assemblies rose substantially. The April rise in personal income was less than half the average gain of the preceding two months, when incomes were swelled by the minimum wage increase and the rise in social security benefits. Retail sales declined somewhat in April, following the extremely sharp gains in the first three months of the year. On the other hand, the erratic housing starts series moved up strongly in April, although building permits declined. Nonfarm payroll employment showed a modest gain over March, in large part attributable to the return of striking workers, and the overall unemployment rate edged down. Given the strength of aggregate demand and the generally tight labor market, cost and price pressures remain very strong.

OUTPUT, ORDERS, INVENTORIES, AND RESIDENTIAL CONSTRUCTION

Industrial output in April held at the record March level, despite the civil disorders which cut into activity early in the month. The Federal Reserve Board's seasonally adjusted index of industrial production held at 162.7 per cent of the 1957-59 base, as virtually all major components were unchanged. Within the manufacturing sector, a decline in production of motor vehicles and parts was offset by a gain in primary metals and by the recovery in the clay, glass, and stone industry following the settlement of the seven-week glassblowers' strike. Automobile output was curtailed temporarily by the events following the death of Dr. King. While some of the lost production was made up later in the month, output for April as a whole fell 3½ per cent from the high March level to a seasonally adjusted annual rate of 8.6 million units. Preliminary figures for May, however, indicate that the assembly rate rose strongly, to a rate of 9.4 million units. Output of primary metals increased sharply in April, on the strength of a partial recovery in the copper industry following the April 8 strike settlement as well as in response to a continued heavy demand for steel inventories in anticipation of a possible steel strike this summer. This step-up in the rate of accumulation began late last fall, and stocks have reached a record level. According to preliminary reports, steel production continued at a high level in May.

The volume of new orders received by manufacturers of durable goods fell to $25.3 billion, $1.0 billion below the high March level. The decline was almost entirely due to a drop in orders for civilian aircraft, which followed an unusually large rise in March. Orders received in the machinery and equipment and in the primary metals industries, however, rose in April. The total volume of new orders continued to exceed durables shipments, and the orders backlog advanced to a new peak of $80.9 billion.

A step-up in the pace of inventory building may buoy industrial production in the near term. In an effort to offset an apparently unintended slowdown in the rate of inventory accumulation in the first quarter, businesses can be expected to raise their rate of inventory spending, although the size of this increase may be limited by a further growth of consumer demand. The behavior of inventory spending has been a key factor in the performance of the economy over the last eighteen months. By the final quarter of 1966, it was apparent that business expectations of a rapid expansion in consumer demand had resulted in a buildup in stocks which far exceeded the requirements of the sluggish sales levels that materialized in the latter part of that year. With the ratio of inventories to sales reaching undesirably high levels (see Chart I), businesses sharply reduced the rate of accumulation in the first half of 1967, gradually bringing stocks into a more normal relation to sales. As measured in the gross national product (GNP), spending on inventories fell from a seasonally adjusted annual rate of $18.5 billion in the fourth quarter of 1966 to $7.1 billion in the first quarter of 1967 and then to only $0.5 billion in the second quarter. This very sharp cutback in inventory accumulation was in good part responsible for the sluggishness which characterized the economy in the first half of last year. By the second half of 1967, a substantial part of the adjustment had been completed, and at the same time the demand situation improved markedly. Inventory spending then began to rise, reaching a seasonally adjusted annual rate of $9.2 billion in the final quarter of the year.

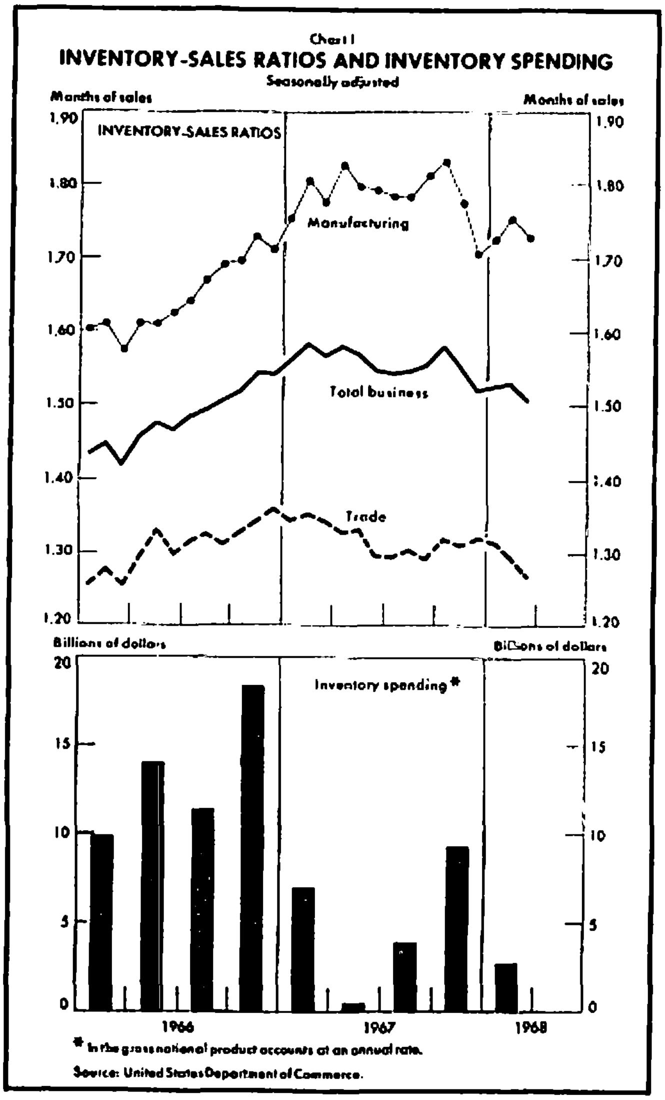

Chart I
INVENTORY-SALES RATIOS AND INVENTORY SPENDING
Seasonally adjusted

* In the gross national product accounts at an annual rate.
Source: United States Department of Commerce.

The first three months of 1968, however, saw a sharp reversal in the upward trend of accumulation. In contrast to the early 1967 situation, this drop in the rate of inventory investment appears to have resulted in part from a surge in consumer demand which exceeded business expectations. The consumer demand component of GNP, measured at a seasonally adjusted annual rate, rose in the first quarter by an unprecedented $16.9 billion.[1] This upsurge was due not only to the rapid expansion of incomes—stimulated by the increases in the minimum wage and social security benefits—but also to consumers' willingness to spend a substantially greater portion of their incomes. The Commerce Department now estimates that the savings rate, which has been running at very high levels since 1966, dropped to 6.6 per cent of disposable income in the first quarter, compared with 7.5 per cent in the final quarter of last year. Taken by itself, this decline in the savings rate accounted for about one fourth of the first-quarter advance in consumer spending. The strong rise in consumer spending cut heavily into business stocks—notably at the trade level—and the rate of inventory accumulation fell from the fourth quarter's $9.2 billion to only $2.7 billion. At the same time, the inventory-sales ratio for total business dropped to the lowest level since mid-1966. Because the first-quarter decline resulted primarily from a larger than expected rise in demand, inventory accumulation may well increase in the coming months. Indeed, in April, manufacturers' inventories rose by $¾ billion, the largest monthly advance since December 1966 and sharply above the $¼ billion average monthly increase of the first quarter.

The residential construction picture was mixed in April (see Chart II). The erratic series on nonfarm housing starts rose 8 per cent to a seasonally adjusted annual rate of 1.6 million units, the highest since early 1964. The number of units authorized by permits issued by local authorities, however, fell in April, perhaps reflecting the recent tightening in the home mortgage market. A considerable part of the strength in residential construction in recent months has come from the apartment-building

[1] The Department of Commerce has revised its preliminary estimate of first-quarter GNP, which was discussed in the May issue of this *Review*. Although final demand was revised up by $0.6 billion, inventory spending was revised down by $1.2 billion. Thus, at a seasonally adjusted $19.4 billion, the first-quarter increase in total GNP is $0.6 billion less than the preliminary estimate.

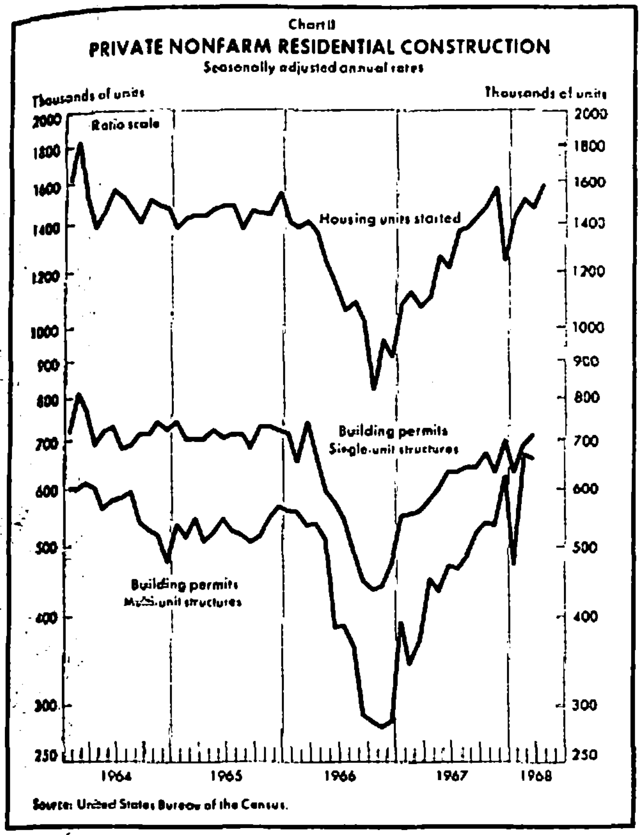

Chart II
PRIVATE NONFARM RESIDENTIAL CONSTRUCTION
Seasonally adjusted annual rates

Source: United States Bureau of the Census.

sector. The relative stability of single-unit permits contrasts with the upward movement in permits issued for multi-unit construction. While this divergence may reflect a shift in demand, many institutional investors have been reluctant to add to their holdings of single-family mortgages while continuing to acquire mortgages on multi-unit dwellings. In part, this policy is due to the fact that in some states there are usury ceilings on single-family mortgage rates which are below current market rates. In general, usury ceilings do not apply to mortgages on multi-unit dwellings.

EMPLOYMENT, INCOME, AND CONSUMER DEMAND

The employment situation remained tight in April. The unemployment rate dropped by 0.1 percentage point to 3.5 per cent of the labor force, matching the lowest rate since 1953. At the same time, the rate for married men—a key sector of the labor force—fell to a record low of 1.5 per cent. As to employment itself, the picture in April was clouded by the civil disorders which affected employment during the survey week. The payroll survey of nonfarm employment, conducted by the Bureau of Labor Statistics, registered a mild advance of about 100,000—chiefly due to the settlement of several labor disputes, notably those involving the glassblowers and copper workers. While the number of workers in mining and manufacturing thus moved up, declines were registered in the construction and trade sectors. Although construction employment has eased slightly for two months, following a very large gain in February, it continues to run at near-record levels.

Employment in the retail sector was particularly affected by the civil disorders. According to the household survey taken by the Bureau of the Census, the number of persons in the civilian labor force and the number employed both declined in April. (Unlike the payroll survey of employment, the household survey treats workers on strike as employed. Thus, the April household survey did not reflect the strike settlements which had a marked influence on payroll employment.) In this survey, the April decline in employment was centered in the number of women holding part-time jobs in the retail sector where curfews and disorders closed stores during the survey week.

The expansion of personal income in April, though about in line with the average monthly increase in 1967, appeared relatively small when compared with the unusually large gains in February and March. In those months, incomes were swelled by the hike in the minimum wage and the increase in social security benefits. In addition to the fact that personal income growth slowed to a more normal rate in April, the month's advance was also dampened by the effects of the nationwide strike by telephone workers.

The moderate April gain in income, set against a background of civil disorders, was accompanied by a decline in retail sales, according to the preliminary report of the Department of Commerce. Among the retail outlets, auto dealers were particularly affected by the disturbances following Dr. King's death, and April auto sales were down by about 10 per cent from March to a seasonally adjusted annual rate of 7.9 million units. Preliminary data for May, however, indicate that sales recovered sharply, rising to a rate of 8.5 million units.

PRICE AND COST DEVELOPMENTS

Prices continue to advance at both the retail and wholesale levels. The consumer price index moved up in April at an annual rate of 4.0 per cent, as prices of food, housing, apparel, and services all rose. The rate of increase in consumer prices accelerated sharply in the spring of last year, and the index has continued to advance rapidly since that time. On a year-to-year basis, consumer prices rose 4.0 per cent over April of 1967—the highest rate of inflation in seventeen years. At the wholesale level, preliminary data for May indicate that a further jump in food prices outweighed a decline in industrial prices, pushing the wholesale price index up by 0.1 percentage point. Following nine months of large increases, industrial wholesale prices eased 0.2 percentage point in May, as copper prices fell from the inflated levels reached during the long strike in that industry.

Recent wage settlements continue to add pressure to the price situation. According to data tabulated by the Bureau of Labor Statistics, major collective bargaining agreements reached during the first quarter resulted in a median wage and benefit increase of 6.2 per cent a year, compared with a median of 5.2 per cent under agreements concluded during 1967. Moreover, the first quarter was marked by an exceptionally large rise in hourly labor compensation averaged for the entire private economy (though a substantial part of the advance was due to the nonrecurring effects of the increases in employer contributions for social insurance and in the minimum wage). Thus, despite a substantial improvement in output per man-hour, unit labor costs in the private economy increased significantly between the fourth and the first quarters.