The Business Situation

The major indicators of business activity point to continued inflationary pressures in the economy. The modest inventory-sales imbalance that developed toward the end of last year appears to have been largely corrected since then by a combination of small further inventory additions, large gains in sales of manufacturing firms, and a reversal of the December decline in retail sales. Industrial production continues to grow, and recent sizable increases in the labor force have been readily absorbed by the intensive demands for new workers. As a result, the unemployment rate has remained at a fifteen-year low. Looking ahead, a Government survey found businessmen planning to increase sharply their plant and equipment outlays this year, reflecting their expectations of strong demand conditions and a generally inflationary cost and price environment. At the same time, leading indicators of residential construction activity have stayed at very advanced levels despite tighter mortgage market conditions, and total construction spending has advanced to record levels. Under these conditions, inflationary sentiment remains firmly entrenched. In a further move to reduce the inflationary pressures in the economy, the Federal Reserve System on April 3 raised the discount rate to 6 percent from 5½ percent and increased reserve requirements against member bank demand deposits by ½ percentage point.

PRODUCTION, ORDERS, AND INVENTORIES

The Federal Reserve Board's index of industrial production registered a gain of 0.4 percentage point in February to reach a seasonally adjusted 169.5 percent of the 1957-59 average. Considerable strength continues to be clearly visible in steel production and in the broad category of equipment. Iron and steel production, though growing much less vigorously than late last year, recorded a solid advance in February, and it appears that output in March was up a little further. Defense-oriented equipment output recovered in February from the previous month's strike-depressed level, and a further increase of about 1 percent in business equipment production brought the overall gain in that sector to more than 6 percent since the current upswing began in September. However, the February advance in overall industrial production was limited by further declines in the production of motor vehicles and parts and of textiles and apparel. There were also reductions in coal and crude oil output that appear to have been strike-related.

The production of consumer goods rose slightly in February. A decline in the automotive products category was more than offset by a further gain in other consumer products. In terms of unit assemblies, domestic auto production slipped to a seasonally adjusted annual rate of 8.4 million units in February from 8.7 million units in January, and apparently remained about unchanged in March. The sharp cutback in production since November, when output was at a rate of 9.2 million units, reflects efforts on the part of the industry to stem rising inventories of new cars at the dealer level.

New orders received by durable goods manufacturers jumped by 3 percent in February to a new high. The growth of the orders inflow was concentrated in the fabricated metals, machinery, and transportation equipment industries. In the latter industry, virtually all the increase was due to a large advance in orders for military aircraft. The backlog of unfilled orders on the books of durables manufacturers rose in February for the seventh consecutive month, also reaching a new peak.

At the end of last year there was some evidence that inventories might be getting out of line with sales, as the overall inventory-sales ratio for manufacturing and trade firms rose significantly. This movement was largely reversed in January, however. Manufacturers' shipments surged upward in that month, and retail sales more than recovered from their December slump. At the same time, inventories rose only marginally in both sectors. Moreover, in February, sales at retail outlets remained at the January peak, according to the advance report, and once again manufacturers' shipments advanced strongly while their inventories rose fairly moderately. Evidence that manufacturers do not consider their current inventory positions to be excessive is contained in a recent Government survey of their inventory spending plans. That survey, by the Commerce Department, found that manufacturers expect to accumulate inventories in the first half of this year at a higher rate than in 1968. The planned second-quarter increase of $2.4 billion, if it occurs, would be the largest quarterly rise in inventories since late 1966.

BUSINESS FIXED INVESTMENT AND RESIDENTIAL CONSTRUCTION

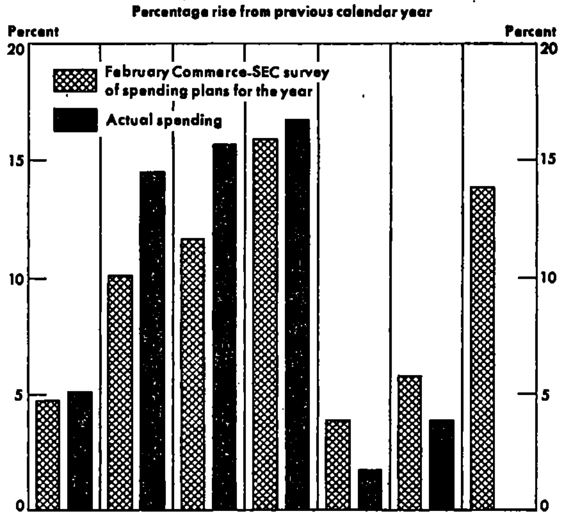
Businessmen plan to increase sharply their spending on plant and equipment this year, according to a recent survey conducted jointly by the Department of Commerce and the Securities and Exchange Commission. The findings of the survey, taken in late January and early February, indicate that capital spending will climb to an estimated $73 billion in 1969, a rise of 14 percent from last year (see Chart I). If this estimate proves accurate, the percentage growth in dollar expenditures for plant and equipment would be of a magnitude approaching the huge gains in the mid-1960's—though inflation is, of course, likely to account for a much larger proportion of the increase this year.

The survey of capital spending plans found strength spread fairly evenly among the major industry classifications. The forecast increases generally range narrowly from 10 percent for the communications-commercial-miscellaneous category to 17 percent for nondurable goods manufacturers. The railroads, which plan a 30 percent advance, are a striking exception to the general pattern. Among manufacturers, particularly large increases are planned by such important industries as chemicals, petroleum, textiles, paper, machinery and equipment, and motor vehicles. In 1968, capital expenditures declined in most of these industries. Planned capital spending by manufacturers overall is up 16 percent in 1969 after having declined last year by 1 percent.

Chart I

PLANT AND EQUIPMENT PLANS AND EXPENDITURES

Percentage rise from previous calendar year



Sources: United States Department of Commerce; Securities and Exchange Commission.

Capital spending has quite obviously been fueled since last summer by expectations of further growth in business sales and profits and further increases in capital goods prices and wage rates. Some additional impetus may also be attributable to speculation that the investment tax credit might be rescinded or reduced. These factors seem to be overwhelming the effects of the past moderate behavior of consumer spending, tightened credit conditions, and much unused capacity.

Thus, even though consumer spending has displayed only moderate growth since last summer, manufacturers reported in conjunction with the Commerce-SEC capital spending survey that they expect 1969 sales to exceed the 1968 level by nearly 8 percent, not much below last year's gain of 10 percent. The retail trade sector, moreover, expects a sales gain this year that would be even larger than the 1968 advance.

The mid-March boost in the commercial banks' prime lending rate to 7½ percent, and the sharp rise in capital market rates generally, may well cause businessmen to readjust their capital spending plans as well as give closer scrutiny to inventory holdings. However, the continued growth of internal funds available for investment spending is undoubtedly helping to buoy plant and equipment and inventory spending. Thus, despite the 10 percent tax surcharge, corporate profits after taxes climbed to a record seasonally adjusted annual rate of $52.9 billion in the final quarter of last year.

The overall capacity utilization rate in manufacturing has been about 84 percent in recent months, significantly below an average of more than 90 percent in 1966. Consequently, it seems likely that 1969 capital spending plans reflect in part a major effort by businessmen to economize on labor through more efficient facilities. Unit labor costs in manufacturing soared by 4.1 percent in 1968, and recent trends in wage rates suggest continued sharp increases in production costs.

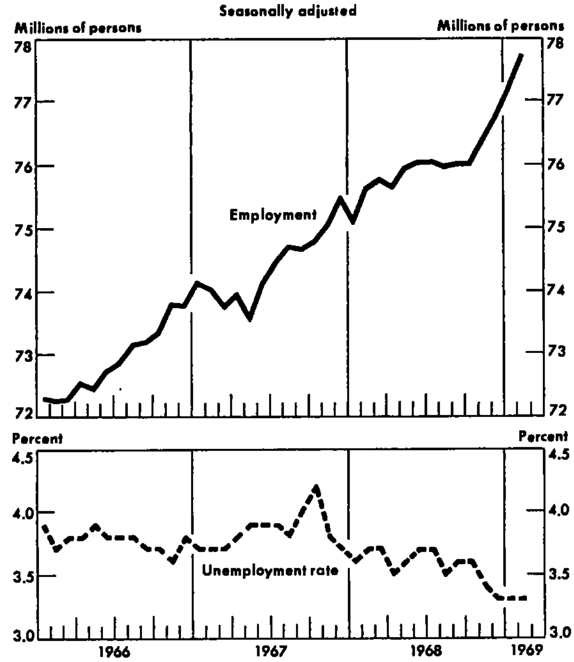
Total spending on new construction set another high in

February, rising to a seasonally adjusted annual rate of more than $90 billion. Public construction outlays increased sharply and, although private nonresidential construction activity was below the previous month's peak, it remained at a very high rate. At the same time, private residential construction rose further in February and the leading indicators of housing activity point to additional increases ahead. Housing starts in January and February averaged well above levels in the closing months of 1968. In January, starts were at an annual rate of more than 1.8 million units, and the February rate of 1.7 million was also very high. At the same time, housing permits recovered vigorously in February after a January dip.

Chart II

TOTAL EMPLOYMENT AND THE UNEMPLOYMENT RATE

Seasonally adjusted



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

EMPLOYMENT, INCOME, AND CONSUMER SPENDING

The demand for labor remains very strong indeed. The unemployment rate in February held at the fifteen-year low of 3.3 percent (see Chart II). A further large increase in the civilian labor force was matched by an advance in employment of ½ million persons, leaving the number of persons seeking work unchanged.

Payroll employment in nonagricultural establishments rose by 335,000 persons in February, the second largest increase in a year. Even after allowance for the extra boost given the figure as roughly 60,000 strikers returned to work, the gain was exceptionally large. Payrolls rose in all the major sectors. There were substantial advances in services, government, and construction, and manufacturing employment was up considerably, largely due to settlement of a petroleum industry strike.

The downward drift of the average workweek of production workers in manufacturing continued in February. From a seasonally adjusted 41.1 hours in September, the average workweek gradually shortened to 40.1 hours in February. The decline appears to be broadly based, and nonmanufacturing sectors of the economy are apparently experiencing a shortening of the workweek as well. This development has been viewed by some observers as an indication of an easing in labor demands. The very substantial growth in employment in recent months, however, weakens the case for this interpretation. It seems more likely that firms are hiring additional workers to reduce costly overtime hours, and perhaps attempting to broaden current employment in anticipation of further tightening in the labor market.

Personal income rose by $5.3 billion in February to a seasonally adjusted annual rate of $721.4 billion. This far exceeded the $2.6 billion gain in January, when a large increase in social security contributions went into effect. Wage and salary disbursements, the major component of total personal income, climbed a substantial $4.2 billion in February. The gain, moreover, was spread very widely across the major industries.

Retail sales data for the past year have recently been revised substantially by the Commerce Department, and now give a slightly different impression of the behavior of consumer spending since last summer. The new figures show that retail demand has been somewhat stronger since last summer than was indicated by the original monthly sales estimates. Nevertheless, it still appears that the tax surcharge has indeed limited the growth of consumer demand. Total sales at retail outlets in February, according to the advance report, were about unchanged from the previous month's high and only 1 percent above last July's level. Durable goods sales, in particular, have shown little buoyancy over the past nine months; this is especially true of the automotive group. February deliveries of new domestic-model autos were given a boost by sales incentive programs and rose to a seasonally adjusted annual rate of 8¾ million units from January's 8¼ million unit rate. However, auto buying then dropped off again in

March to an annual rate of about 8¼ million units, far below the 9 million unit rate of domestic car sales last October.

PRICE DEVELOPMENTS

The consumer price index climbed steeply again in February, rising at an annual rate of 5 percent despite a slight decline in food costs. The prices of nonfood items soared at an annual rate of 7 percent, the most rapid increase since last October, and the durable goods component showed the largest increase for any month since November 1958. The costs of services also continued to move up at a swift pace, with medical care, home maintenance, and mortgage interest costs leading the advance.

Wholesale prices have been increasing at a sharply accelerated pace thus far this year. In March, the index of industrial commodities prices rose another 0.5 percentage point to 111.9 percent of the 1957-59 average, according to the preliminary report. This brought the increase for the first three months of the year to an extraordinarily high annual rate of 6 percent. In contrast, prices of industrial commodities rose at an annual rate of less than 4 percent over the final three months of 1968 and at a rate of less than 2½ percent in the previous nine months. Wholesale prices of farm products also moved up sharply in March to bring their increase for the year to 12 percent at an annual rate. Processed foods and feeds, on the other hand, remained fairly stable for the second month in a row, but such prices had jumped very sharply in January.