The Business Situation

The economy has apparently eased somewhat further. Thus, industrial production, employment, working hours, and private wage and salary payments all declined in May. Although the unemployment rate dropped back to 4.7 percent in June, employment fell again, resulting in the first three-month decrease in seven years. Despite the evidences of weakness, the prospects remain reasonably good for renewal of growth in the economy in the not-too-distant future. Contrary to widespread reports of consumer pessimism, the available sales data suggest that consumers have in fact responded to recent Government measures bolstering incomes. An additional boost to spendable income occurred on July 1, when the remaining 5 percent tax surcharge expired. Similarly, housing permits have been rising of late and, with an improved flow of funds into savings institutions, some strengthening in residential construction outlays seems likely in the last half of the year. Moreover, state and local spending will almost certainly continue upward in the coming months. According to the latest Government survey, business plans for an increase in plant and equipment spending this year have been cut back somewhat. This was to be expected, however, and the cuts reported have not been drastic, with spending plans outside manufacturing holding up quite well. Inventory spending has been reduced sharply in 1970 and, while there are still some areas of excess inventory, the greater part of the adjustment in this sector may have been completed. Finally, the policy actions taken by the Federal Reserve earlier in the year have resulted in moderate growth in the money supply and bank credit so far this year, in contrast to little or no growth in the last half of 1969. The recent decision to suspend Regulation Q ceilings on short-dated large certificates of deposit[1] will also help to maintain an adequate overall flow of credit. Inflation remains a most serious problem. There have been a few encouraging signs here and there, but the major price indicators have not as yet shown convincing evidence of a more moderate trend.

[1] See "Money and Bond Markets in June", this *Review*, page 154.

PRODUCTION AND ORDERS

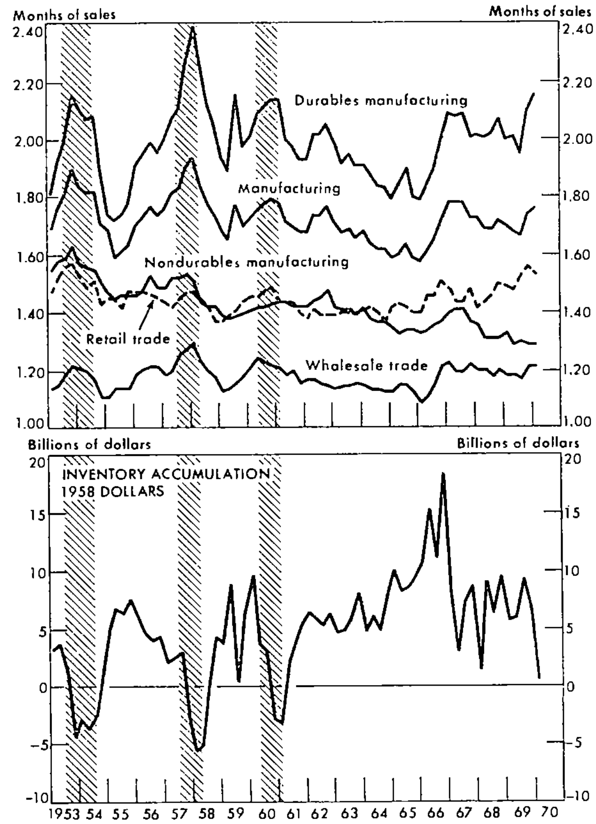
Industrial output in May recorded one of the larger declines in the downtrend that began last July. The Federal Reserve Board's index of industrial production dropped by 0.8 percent to 169.0 percent of the 1957-1959 average (seasonally adjusted). This was the lowest level since December 1968 and was 3.2 percent below last July's high. The downtrend had been interrupted last February and March by a small recovery, which had led some observers to believe that the production slump had bottomed out. Recent production data have been difficult to interpret, since the figures have been heavily influenced by labor disputes. The February settlement of the General Electric strike helped boost production in March, and in both April and May work stoppages by truckers caused shortages of some component parts used in production lines. Strikes in the rubber industry also dampened production in May. However, the May decline in the overall production index was widespread.

The big drop in the index occurred among equipment producers. Output among defense industries fell again, reaching a level almost 20 percent below last year's average. Production of business equipment also dropped in May, falling to a level about 6 percent below last October's peak. Iron and steel output eased in the month, although steel ingot production, which accounts for about half the iron and steel index, moved up in June. Recent levels of iron and steel output have run almost 10 percent below last year's peak, and there have been newspaper reports that some price concessions are being made.

In contrast to the general easing, auto output jumped 15 percent in May to a seasonally adjusted annual rate of 8 million units. This uptrend continued in June, when out-it rose further to 8½ million units. The recent strength in auto production followed several months of slackening. In the second quarter, assemblies averaged 7¾ million units, compared with 6¾ million units in the first three months of the year and 7¾ million units in the final quarter of last year. The recent uptrend largely parallels the recovery in auto sales. After bottoming at a seasonally adjusted annual rate of 6¾ million units in January, the sales pace for domestically produced cars has risen rather steadily, reaching 7¾ million in May. In June, sales advanced sharply to an annual rate of 8½ million units. Better auto sales have led to a reduction in dealers' inventories. By May, the inventory-sales ratio for dealers had fallen back to the 1969 average.

The volume of new orders for durable goods, a leading indicator of industrial activity, rose $0.9 billion to a seasonally adjusted rate of $29.6 billion in May, as orders for transportation equipment—which are often erratic—surged. Durables orders have generally been weak since last fall, however, and even the strong May advance left orders at a level $2.5 billion under the September 1969 peak.

Chart I
INVENTORY SALES RATIOS AND INVENTORY ACCUMULATION
Seasonally adjusted



Note: Shaded areas represent recession periods, according to the National Bureau of Economic Research chronology.
Source: United States Department of Commerce.

INVENTORIES, SHIPMENTS, AND RESIDENTIAL CONSTRUCTION

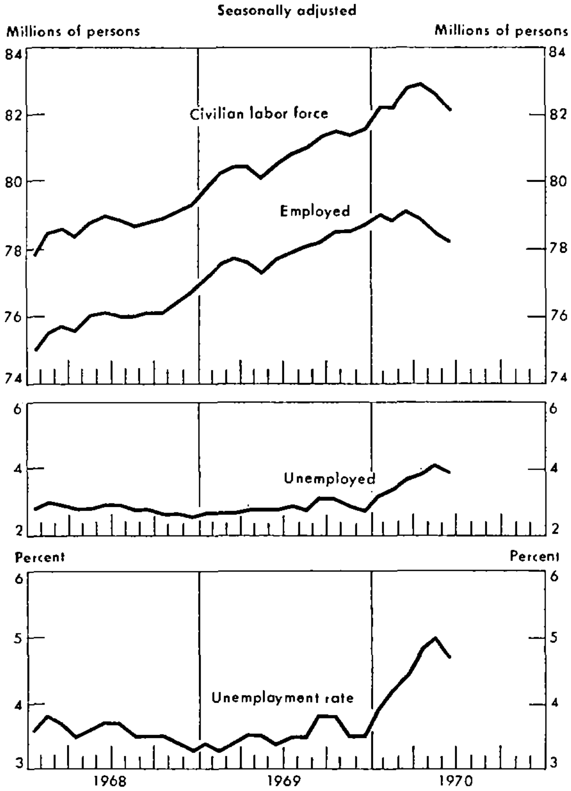
Business inventory accumulation apparently continued at a slow pace during the first two months of the second quarter. In April, total business inventories rose by $700 million. While this was above the average gain of the first quarter, it was well below the $1 billion average monthly increase of last year. Moreover, a part of the April rise apparently resulted from the truckers' strike which interrupted shipments that month. May data, which are available for manufacturing only, indicate that manufacturing inventories did not rise at all that month. Despite the small advance in inventory spending this year, there are some areas where stocks still appear to be high in relation to sales. As has generally been the case in past slowdowns, this problem is centered in durables manufacturing, where the inventory-sales ratio in May was only slightly improved from the first-quarter level shown in Chart I.

Residential construction activity continued sluggish in May, but there were some indications that the situation might improve. The volume of private housing starts remained at April's seasonally adjusted annual rate of 1.2 million units, compared with 1.5 million units started last year. While the starts rate continued low, the volume of building permits issued by local authorities rose for the second month in a row, reaching the highest level in a year. The recent strength in this series suggests some pickup in building activity in the coming months. Underlying demand for new housing—as shown by near-record lows in vacancy rates and by the rapid growth of household formations in recent years—remains very strong. Moreover, the outlook for home building has been improved by higher deposit inflows to thrift institutions and also by the likelihood of increased Federal assistance to the home mortgage market.

EMPLOYMENT, INCOME, AND CONSUMER DEMAND

The economic slowdown has been very evident in the labor market (see Chart II). Over the first six months of the year the unemployment rate increased from 3.5 percent to 4.7 percent, according to the household survey of employment. A part of this increase reflected declines in employment, but an unusually rapid expansion in the civilian labor force also added to the pool of those unsuccessfully seeking work. This acceleration in the labor force was rather unexpected, since a softening in job markets generally leads to a slowdown or an outright reduction in labor force growth as many persons, particularly women and teen-agers, simply leave the labor force after losing a job. (To be included in the civilian labor force, as officially defined, a person must be employed or have actively sought employment within thirty days prior to the survey date.) While the explanation for the labor force acceleration earlier this year is not completely clear, the labor force did revert to more normal behavior in May and June, dropping on a seasonally adjusted basis by a sharp 750,000 in the two months and wiping out better than half the 1.3 million gain registered in the January-April period. The two-month decline was almost entirely accounted for by adult women and teen-agers. In June, teen-agers evidently entered the job market in substantially less than usual numbers, perhaps discouraged by widespread reports that summer employment would be scarce this year. (Spokesmen at the Bureau of Labor Statistics, however, have warned that seasonal factors are particularly difficult to assess in June.) Also in June, seasonally adjusted employment of adult women rose; as a result, total employment did not drop as fast as did the labor force. Thus the unemployment rate fell back 0.3 percentage point from its five-year high of 5.0 percent registered in May.

Chart II
THE CIVILIAN LABOR FORCE, EMPLOYMENT, AND UNEMPLOYMENT
Seasonally adjusted



Source: United States Department of Labor.

The payroll series on employment, which is a survey of employers rather than of households, also pointed to large employment declines in May and June. The total decrease in those two months amounted to 0.5 million, with over 0.3 million of that taking place in manufacturing. Since manufacturing employment peaked last September, the number of persons on manufacturers' payrolls has dropped by 0.8 million, with most of the decline accounted for by durables industries. The workweek of production workers in manufacturing also eased 0.2 hour in May to 39.8 hours, almost a full hour below last year's high, and remained unchanged at this level in June.

Declines in employment and the workweek led to decreases in private wage and salary payments in April and May (June data are not yet available). However, this weakening has been offset by Federal Government actions which have maintained the overall growth of personal income. Total personal income rose by a record $18 billion in April, and declined by $8 billion in May to a seasonally adjusted annual rate of $794 billion. April income had been given a tremendous boost by the 6 percent Federal Government pay raise and the 15 percent social security hike, both of which were retroactive to January. The social security increase alone had added $12½ billion to April incomes, and $8 billion of that represented nonrecurring makeup payments. These makeup payments were absent in May and accounted for the April-to-May decline in total personal income. (The retroactive portion of the 6 percent Government pay raise granted in April was divided equally between April and May and amounted to $3 billion in each month.) The pay raise and the hike in social security payments were large enough so that they not only masked the decline in private wage and salary disbursements, but they even brought the recent growth of personal income to nearly the same rate as last year. Over the first five months of the year total personal income rose at a 7.1 percent annual rate, only a shade below last year's 7.6 percent advance.

Federal actions underpinning personal income were generally expected to stimulate consumer buying, and the mited figures so far available are at least consistent with this view. Retail sales in April climbed by $0.6 billion and in May backed off only slightly from that high level. The fragmentary evidence so far available for June, including the strong performance of auto sales noted earlier, suggests that overall sales may have been rather well maintained in the month.

RECENT PRICE DEVELOPMENTS

There has been little solid evidence to date of a general slowdown in the rate of price advance. The consumer price index climbed at a 6.3 percent seasonally adjusted annual rate in May, virtually the same as the rate of increase for all of 1969 and for the first four months of this year. To be sure, without seasonal adjustment the index in May increased from the April level at a more moderate 5.4 percent annual rate, but this statistic is less meaningful than the adjusted figure since some prices, such as those for food, are normally a bit lower in May than in April.

Industrial wholesale prices have also continued to gain rapidly despite wide expectations of easing. In May industrial prices rose at a 4.1 percent annual rate, compared with a 4.2 percent rate in the first four months of the year and a 4.0 percent hike in 1969. A good part of the May rise occurred in prices of fuels, lumber, and iron and steel products. There was a slowing in the rate of advance in industrial prices in June, but this apparently reflected little more than a normal seasonal development. In contrast to the uptrend in industrial prices, the total wholesale price index has risen slowly so far this year, as declines in agricultural prices—which make up a quarter of the total index—have offset most of the advance in industrial costs. The agricultural declines suggest some letup in the rise of consumer food prices, but the current inflation is rooted in developments clearly outside the farm sector.

Recent trends in labor compensation and productivity suggest labor costs will continue to exert pressure on the price level. When increases in compensation per man-hour are not matched by equal gains in productivity (output per man-hour), the labor cost per unit of output rises. Since 1965, gains in compensation per man-hour have outstripped productivity increases and have pushed up unit labor costs. These advances have been major factors in the current inflation. So far this year the situation has shown little improvement, except in the manufacturing sector where layoffs and reductions of expensive overtime work have helped to hold down costs.