The Business Situation

The economic recovery continues to be moderate. Thus, although industrial production posted a strong and broadly based advance in May, the overall recovery from the November trough is still relatively small. The decline in the unemployment rate in June to 5.6 percent from May's reported 6.2 percent was associated with a record fall in the civilian labor force, suggesting that the reduction in the unemployment rate may not necessarily signify an important improvement in labor demand conditions. Personal income registered a relatively large increase in May, although growth of personal income this year has so far been modest when special factors are excluded. In June, personal income soared as the rise in social security benefits took effect. This initial payout included lump-sum retroactive payments to the first of the year, so that the total advance in income was huge. One area of major strength continues to be the residential construction sector, and a very large jump in building permits during May suggests that further gains are quite possible over the near term. The overall inventory situation appears to be favorable. The pace of inventory spending accelerated in the March-April period, yet equally strong gains in business sales left the inventory-sales ratios in most sectors well below their year-end levels. Inventories of manufacturers advanced only slightly further in May, as shipments rose sizably.

The price situation is thoroughly unsatisfactory. Industrial wholesale prices recorded very large advances for the three months ended in May, and the consumer price data for May show sizable increases in virtually every product grouping. The most discouraging aspect in the May consumer price performance was the sharp acceleration in the rate of advance in nonfood commodity prices, which had shown a marked trend toward moderation earlier in the year. Price increases of the magnitude experienced recently are without precedent in other periods of economic slack since the Korean war.

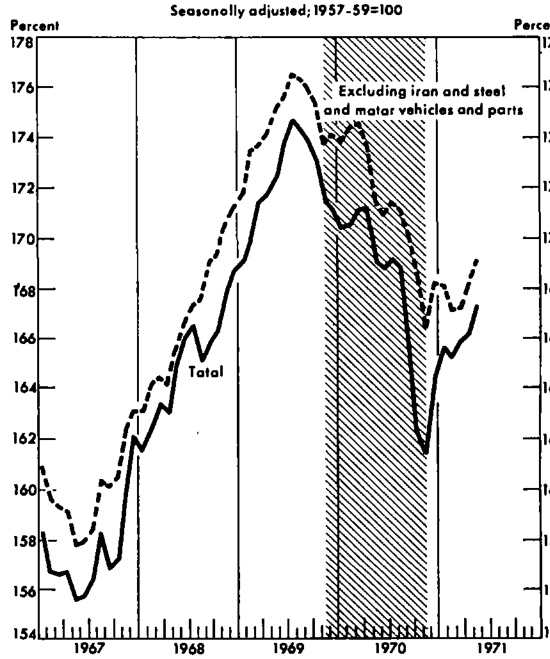
PRODUCTION AND ORDERS

The Federal Reserve Board's index of industrial production registered a sizable gain of 0.7 percent in May (see Chart I). However, the recovery in production from the low point reached last November has been relatively mild, amounting to 3.6 percent. This increase is smaller than that recorded in the first six months of the recoveries from other recessions in the post-Korean war period. Six months after the February 1961 trough, for example, production had risen 7.6 percent—more than twice the recent rise. The comparison is even less favorable for the current production recovery when consideration is given to the major role that strike-related factors have played in the advance over the six months ended in May. In recent months, however, there have been in-

Chart I

INDUSTRIAL PRODUCTION

Seasonally adjusted; 1957-59=100



Note: The National Bureau of Economic Research has tentatively placed the peak and trough points of the recession at November 1969 and November 1970, respectively. Data for latest four months are subject to revision.

Source: Board of Governors of the Federal Reserve System.

creasing signs of a general strengthening of production outside the automobile and steel industries where output has been swollen, in the first case, by recovery from a strike and, in the second, by expectations of a strike.

Excluding the automobile and steel industries, industrial output has risen for three successive months by a total of 1.2 percent. In terms of market groupings, output of nonautomotive consumer products, which accounts for nearly one third of the overall production index, has been an area of pronounced strength. Since its November low, output of these goods has risen 3.2 percent, with almost all components recording substantial increases in recent months.

One factor aiding the May performance was a leveling in the long downtrend in both business and defense equipment production. The earlier decline in defense output, which directly accounts for about 3½ percent of overall industrial activity, has been so large that production is now down to about the level existing in the first half of 1965. This decline, of course, followed a climb in output of over 60 percent between the mid-1965 start of the Vietnam buildup and the mid-1968 peak in arms output. Production of equipment for business purposes, which accounts for about 12 percent of the production index, has also been a substantial factor in the weakness in overall activity in the past two years. In May the index of business equipment output was 15 percent below its October 1969 peak.

The May increase in output of motor vehicles and parts was about the same size as the overall advance, and that for steel a bit stronger. Output in the steel industry has climbed rapidly this year in response to inventory-stockpiling demands by steel users, who have been hedging against a possible strike when the steel industry's labor contract expires on July 31. According to industry spokesmen, however, the climb in production is about over. Stockpiling had been dampened this year by the sluggish nature of the economy and by the likelihood that a large number of mills would continue operating even if other firms were struck. Foreign steel has not been a major factor in curtailing the inventory buildup. Voluntary steel import quotas for 1971, although greater than in 1970, are substantially smaller than the amount imported in 1968, when the industry also went through an inventory-hedging cycle. Moreover, hedging by steel consumers may have peaked in June, rather than later this summer, as users attempted to acquire additional stocks in advance of further steel price increases.

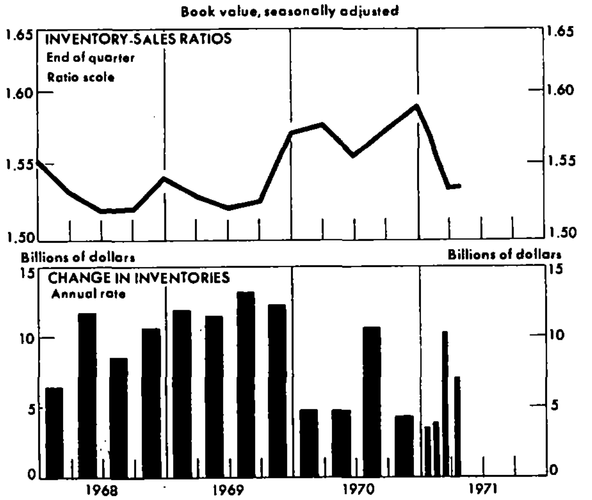
The recent seesawing in new orders for durable goods sheds little light on the outlook for industrial production. In May, the volume of new orders received by manufacturers of durable goods rose by $0.4 billion. While the climb was broadly based, it followed two successive monthly declines including a very large drop in bookings during April. Thus, at the May rate of $31.1 billion, durables orders remained 2.5 percent below their February peak. Excluding the volatile transportation equipment group, however, orders in May were substantially above the February level.

BUSINESS INVENTORIES AND SALES

One of the most reassuring developments in the current outlook is that businessmen appear to have begun stepping up the rate of inventory accumulation. In April the book value of manufacturing and trade inventories rose at a seasonally adjusted annual rate of $7.2 billion (see Chart II). While below the $10.3 billion gain registered in March, the April rate was well above the average rate of only $4.1 billion during the previous five months. It is also noteworthy that about two thirds of the April rise in inventories occurred outside the automotive and steel industries. This contrasts sharply with the experience of the first quarter, when inventories held by other industries actually declined. Despite the relatively large overall rise in inventory spending in March and April, inventory-sales ratios were little changed, since business sales kept pace with additions to stocks. For example, the inventory-sales ratio for all manufacturing and trade businesses combined was 1.53 in April, little changed from the March level and decidedly below the position at the beginning of the year. Preliminary data for May, which so far are available for manufacturing only, indicate a further improvement in the inventory-sales ratio of that sector. Manufacturers added only $100 million to stocks in May, while shipments jumped by $700 million.

The moderate levels of the inventory-sales ratios suggest that improved sales are likely to be accompanied by stepped-up inventory accumulation which will, in turn, provide further impetus to the recovery. Earlier slowdowns in economic activity have each been characterized by a pronounced drop in inventory spending. When economic activity began to taper off, businesses first experienced a run-up of excess stocks as sales expectations failed to be realized. Businesses then responded to this situation by reducing their rate of inventory investment, and this in turn led to cutbacks in orders and production. A distinguishing element in the current cycle was that the rate of inventory spending was kept relatively low before the economic activity peaked late in 1969. In the third quarter of 1969, the quarter immediately preceding the period now tentatively designated by the National Bureau of

Chart II
INVENTORY ACCUMULATION AND INVENTORY-SALES RATIOS FOR TOTAL BUSINESS
Book value, seasonally adjusted



Note: Data for 1971 are monthly. Changes are from end of quarter to end of quarter.
Source: United States Department of Commerce, Bureau of the Census.

Economic Research as the peak of the expansion, inventory accumulation on a book value basis was running at a seasonally adjusted annual rate of $13 billion. Over the next two quarters, spending fell by $8 billion to a $5 billion rate. By comparison, in the fourth quarter 1966, which preceded the slowdown of 1967, inventory accumulation had climbed to an $18½ billion annual rate, and then in the following two quarters dropped by almost $16 billion to an annual rate of $2½ billion. The smaller size of the swing in the current cycle helped moderate the severity of the downturn.

RESIDENTIAL CONSTRUCTION

Activity in the residential construction sector continues to be vigorous. Spending for new private residential housing has climbed sharply this year. By May, outlays were running at a rate fully 15½ percent above the December level. The outlook for continued strength in this area remains firm. The volume of private housing starts rose to a seasonally adjusted annual rate of 1.93 million units in May, marking the third successive month in which starts have run at an annual rate of 1.9 million or higher. Thus, it now appears that the average number of starts in the half year ended in June will be well above the 1.8 million unit mark. This compares with an average of 1.6 million in the second half of 1970 and 1.3 million in the January-June period of last year. The recent starts data also show continuing strength in single-family units, which tend to have a higher unit value than do apartments. The building permits data for May indicate that further advances in housing starts are likely in the months ahead. Indeed, in May, the volume of newly issued building permits rose by a substantial 230,000 units on a seasonally adjusted annual rate basis. At the May level of 1.87 million units, the permits series far exceeded the previous record level for a single month. It might also be noted that there is still a fairly substantial backlog of building permits for residential structures which have not yet been started. This too suggests that the residential construction sector should continue to show gains in the months ahead.

PERSONAL INCOME AND EMPLOYMENT

In May, personal income rose by $6 billion, a gain of 8.6 percent in annual rate terms, equal to the average monthly increment in personal income so far this year. However, when allowance is made for special nonrecurring factors, the May rise was one of the two largest in the last twelve months. The overall advance in income was paced by a $3.9 billion rise in private wage and salary disbursements. Increased hours contributed to a substantial strengthening in the manufacturing sector, where income trends have been the weakest. Transfer payments continued to surge ahead in May, moving up by $1.1 billion. Last month the 10 percent increase in social security benefits, including retroactive payments to the first of the year, caused an unusually large spurt in these payments.

After improving for several months, nonagricultural employment in June suffered a puzzling setback which completely wiped out the gains of the previous three months. The overall decline totaled 300,000, with the number of persons on the payroll in manufacturing and trade establishments falling by about 100,000 each. Declines elsewhere were relatively small. The employment series that is based on a survey of households rather than firms indicated the June employment decline was accompanied by an unprecedented fall in the civilian labor force of 1 million persons. The labor force series has recently been volatile—growing by a total of 700,000 in the previous two months. Although a shrinkage in June seems reasonable, the size of the decline suggests that there may have been unusually difficult seasonal adjustment problems, particularly in the teen-age component. The fall in the labor force far outweighed the decline in employment, and the seasonally adjusted unemployment rate thus fell from 6.2 percent in May to 5.6 percent in June, the lowest since last October.

RECENT PRICE DEVELOPMENTS

In May the upward trend in consumer prices accelerated sharply to a 6.7 percent seasonally adjusted annual rate of increase, the steepest one-month advance since February 1970. During the first four months of 1971, consumer price increases had moderated considerably relative to the experience of the two preceding years, although the degree of this moderation had been exaggerated by falling mortgage interest rates. In May, the decline in mortgage rates came to a virtual halt and, as a consequence, this factor did not exert any sizable further drag on the rise in services prices. Prior to May, the other major factor accounting for the more moderate rise in the overall consumer price index had been the very modest rise in nonfood commodity prices. In May, however, these prices soared at a seasonally adjusted annual rate of 8.3 percent. Sharply higher apparel and used car prices contributed significantly to the acceleration in nonfood commodity prices. The apparent deterioration of consumer prices, combined with the continued steep climb of industrial wholesale prices, suggests that little progress has been made in combating inflation.