The Business Situation

While the latest readings of business statistics point to further slippage in economic activity, they also suggest that the low point of the recession may be reasonably near at hand.* Industrial production declined again in April, but the drop was the smallest since August 1974. No doubt this cutback in production reflects the ongoing inventory correction. The book value of manufacturers' inventories fell in April for the second consecutive month, with the decrease probably fairly substantial in physical terms. Although inventories still appear to be high in relation to sales, and it is thus difficult to determine how much further inventory liquidation will be carried, the recent rate of liquidation seems unlikely to be intensified further.

Meanwhile, other signs of a possible improvement in the economic weather have begun to accumulate. Manufactured durable goods orders rose in April for the second time in three months. This increase was the largest in more than seven years and was broadly based as well. Personal income also advanced in April, and retail sales increased despite a relapse in auto sales. Looking ahead, as the tax cut takes effect and rebate checks are distributed, sales should receive additional stimulus. While residential construction has not yet pulled out of its slump, housing starts did manage a mild increase in April and building permits climbed to the highest level since last August. Labor market conditions weakened further in May, as a sharp rise in the civilian labor force helped push the unemployment rate up to 9.2 percent. Nevertheless, total employment did manage to increase for the second consecutive month.

The price news was mixed in April and May, but on balance the recent pattern of more moderate overall inflation continues to prevail. Consumer prices rose faster in April than in the two previous months, as food prices increased after two months of decline. While the advance of nonfood commodity prices also accelerated somewhat in April, the overall increase in these retail prices in the February-April period was slower than in any other three-month interval in more than two years. At the wholesale level, prices rose for the second consecutive month in May, as prices for farm products and related items moved higher. On the other hand, increases in industrial commodity prices continued to be encouragingly mild. In May, wholesale industrial prices edged up at a 2.1 percent annual rate. Increases in prices of fuel and power accounted for most of this rise, so that if energy is excluded industrial wholesale prices barely changed.

INDUSTRIAL PRODUCTION AND CAPACITY

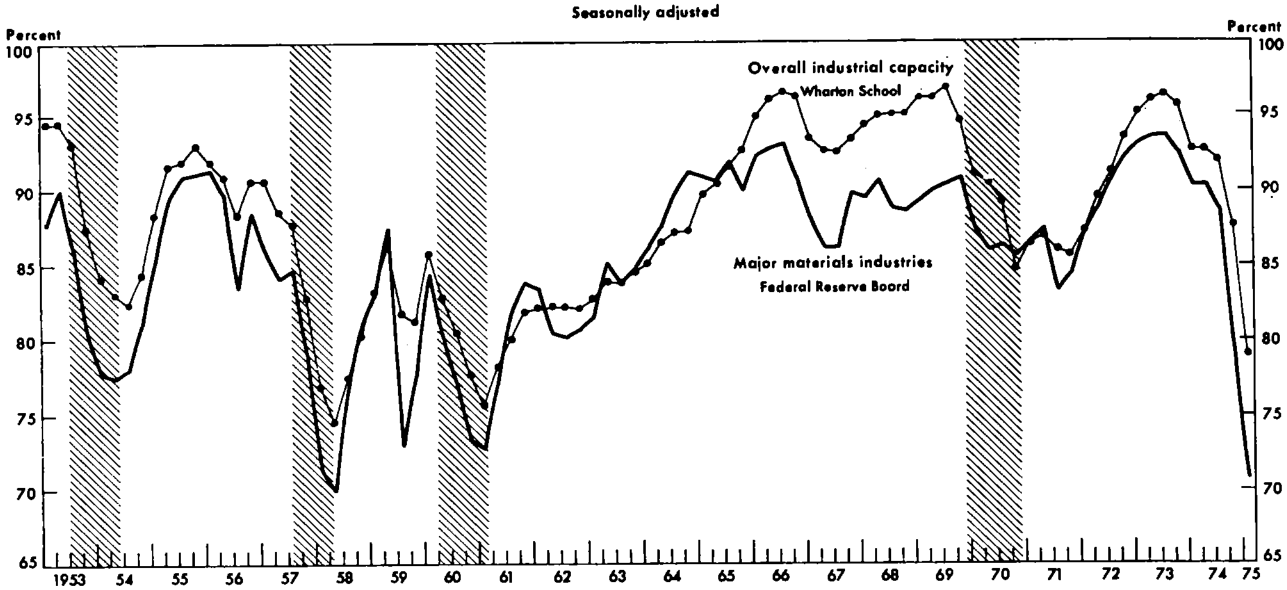
As measured by the Board of Governors of the Federal Reserve System, industrial production fell 0.4 percent in April, thereby dropping 14.2 percent below its peak of November 1973. The most recent decline in this measure of the nation's output of factories, mines, and utilities was the smallest since last August. As in previous months, the production of business equipment and industrial materials posted sizable reductions. However, the output of consumer goods rose modestly in April, the first such increase since last June. Although the production of nondurable consumer goods rose somewhat, the overall increase chiefly reflected a rise in the output of durable consumer goods, especially automobiles. Encouraged by the success of the price-rebate program and anticipating the traditional spring upturn in automotive sales, manufacturers in April boosted production 26 percent above the average first-quarter rate. In May, automotive production rose even higher. Unfortunately, however, domestic auto sales have been sluggish in recent months, and the increased production has been added to the stock of unsold cars.

*Revised estimates indicate that current-dollar gross national product (GNP) fell $13.8 billion, instead of $11.7 billion, at a seasonally adjusted annual rate in the first quarter of 1975. Inventory liquidation was revised from $18 billion to $19.2 billion, and consumer spending was less robust than initially estimated, rising $17.4 billion instead of $20.5 billion. In real terms, GNP declined 11.3 percent instead of 10.4 percent as initially reported, while the annual rate of change in the implicit price deflator for GNP was revised slightly from 8 percent to 8.5 percent.

Chart I

MEASURES OF CAPACITY UTILIZATION

Seasonally adjusted



Sources: University of Pennsylvania, Wharton School of Finance and Commerce; Board of Governors of the Federal Reserve System.

Quite unlike the situation that prevailed at the end of 1973, the economy is now operating well below its productive potential. Indeed, some observers have suggested that there is now more slack and unused resources in the economy than at any time since the end of the Great Depression. This seems to be an overstatement, however. Rather, the evidence would appear to justify the view that the current level of excess capacity is more like that experienced during the 1957-58 and 1960-61 recessions than that experienced just prior to World War II.

The Federal Reserve Board compiles two indexes which measure the utilization of the physical stock of plant and equipment in the manufacturing sector and in the major materials industries, respectively. While the index for manufacturing reached its lowest level in twenty-two years in the first quarter, there is reason to believe that this measure has tended to overstate capacity in recent years and hence this reading should be discounted to some degree. The major materials capacity utilization series appears to be a more accurate measure. Unlike the index for total manufacturing, utilization rates among the twelve major materials producers are based on estimates of maximum output. Although its coverage is limited, this indicator does succeed in measuring the extent of aggregate demand pressures at the initial stage of the production process. Indeed, output in the primary processing industries was severely strained during the 1973 boom, causing serious bottleneck problems throughout the entire economy. The major materials utilization rate reflected these pressures, as it climbed to a peak of 93.5 percent in the third quarter of 1973 (see Chart I), with some basic industries producing at nearly 100 percent of capacity. Since then, of course, the utilization rate has fallen. In the first quarter of 1975, the extent of used plant and equipment in this subsector equaled 70.7 percent. At this level, the index stood midway between the lows attained in the 1957-58 and 1960-61 recessions.

In addition, there is the Wharton School comprehensive index of capacity utilization which reached an exceptionally high rate of capacity utilization in the third quarter of 1973 of 96.2 percent. As of the first quarter of this year, this index had dipped to 78.5 percent. At this level, it was still above the lows of 73.3 percent and 74.2 percent, respectively, reached in the 1957-58 and 1960-61 recessions. Overall, judged in terms of unused plant and equipment capacity, the current level of excess capacity is substantial but not more so than in the two earlier major postwar recessions.

The most popular single measure of slack in the labor market is the overall unemployment rate (see Chart II). In May the jobless rate reached 9.2 percent of the civilian labor force, the highest level since 1941. However, this may exaggerate the current degree of labor-market slack to some extent, since any historical comparison is affected by the dramatic changes in the composition of the labor force that have occurred during the postwar period. For example, women and young men have higher average unemployment rates than adult men, in part because their attachment to the labor force is weaker. The proportion of women and young men in the labor force has increased substantially in recent years, and this has tended to raise the overall unemployment rate irrespective of the demand for labor. In comparing the current jobless rate with that of earlier years, it may be more meaningful to adjust the recent data for this shift in labor-force composition by restoring the relative importance of the major age-sex groups to, say, 1956 levels. On this basis, the current unemployment rate equals 8.1 percent, which is just slightly higher than the peak rates of 1958 and 1961. Moreover, at 5.8 percent in May, the jobless rate for men aged twenty-five and above is about equal to the peak rate in 1961 but below the 1958 rate. At least in some respects then, current labor-market slack is roughly comparable to the 1958 and 1961 situations.

APPROPRIATIONS, MANUFACTURERS' ORDERS, AND INVENTORIES

According to the Conference Board's survey of the 1,000 largest manufacturing firms, appropriations for new plant and equipment dropped 9.4 percent in the first quarter of this year. And over the six-month period ended in March, newly approved appropriations fell 33.2 percent, the largest two-quarter decline since 1957. Reduced spending plans by durable goods manufacturers were entirely responsible for the latest slide, as appropriations by nondurable goods producers picked up somewhat. Cancellations of previously approved projects have also stepped up markedly in these two quarters, primarily because of postponements in the spending plans of the petroleum industry. As a result, net new appropriations are currently at the lowest level in two years.

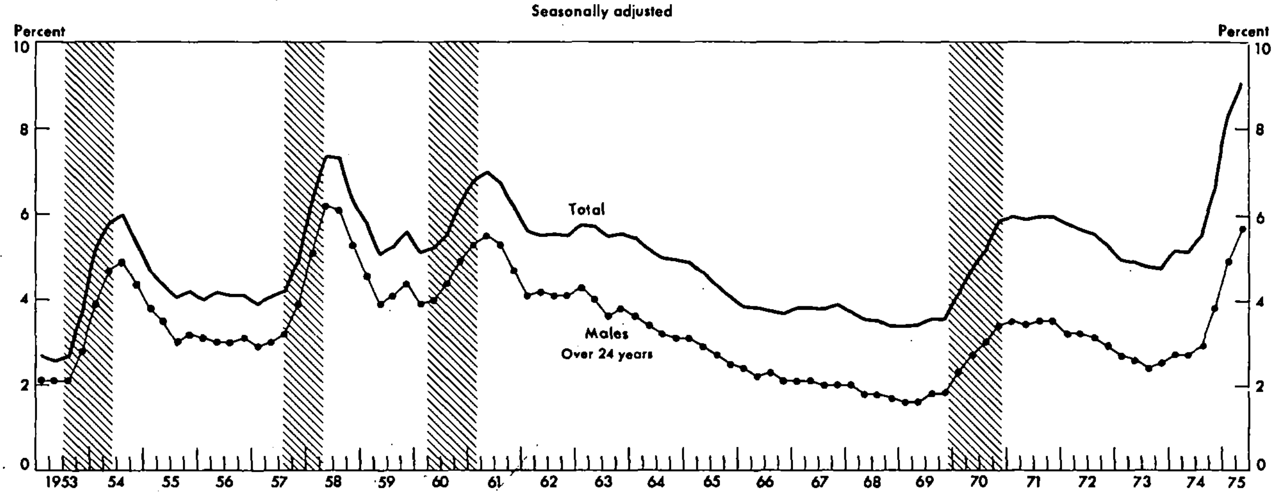
The flow of new orders received by durable goods manufacturers surged upward by 9.7 percent in April. Although new bookings were still 21 percent below the peak reached last August, the most recent increase was the largest in more than seven years, and it raised durables bookings to the highest level since last November. Despite this jump, shipments rose even faster and the backlog of unfilled orders fell to the lowest level in one year.

Historically, a sustained increase in durables orders has

Chart II

UNEMPLOYMENT RATES

Seasonally adjusted

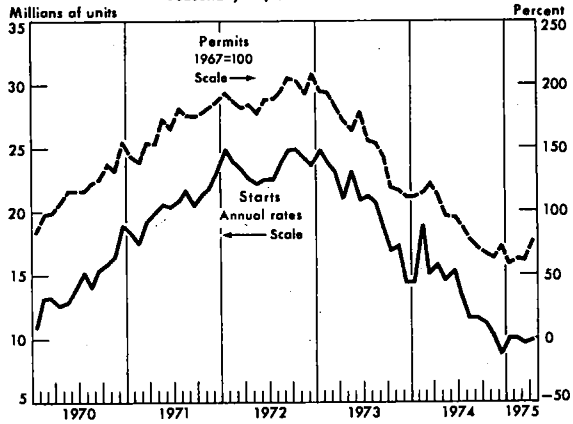


Note: Unemployment rates for the second quarter of 1975 are an average of April and May.
Source: United States Department of Labor, Bureau of Labor Statistics.

typically been a forerunner of increases in production. While the April advance could of course be reversed in subsequent months, orders have now increased in two of the last three months, thus providing some support for the view that the economy appears poised for recovery. This conclusion seems more likely, since the April jump in orders was widespread among all industrial sectors. Bookings for transportation equipment registered the largest advance, but the increase in bookings for machinery and primary metals was also sizable. Orders for nondefense capital goods also jumped for the first time since last September. However, while the increase was rather large, orders for nondefense capital goods just barely managed to climb above the level recorded four months ago.

Manufacturers succeeded in reducing inventories of both durable and nondurable goods in April for the second consecutive month. With stocks falling by $1.15 billion, this latest round of inventory liquidation exceeded the previous month's drop and was the largest in percentage terms since May 1958. Declining inventories of nondurable goods accounted for most of the drop, as stocks of both finished goods and materials fell by a sizable margin in this sector. While the ratio of nondurable inventories to sales is now at its lowest level since last November, stocks of durable manufactured goods still seem to be high in relation to current sales. In April, manufacturers' inventories of durable goods declined only modestly, as a reduction in materials and supplies offset increases in work in progress and in finished goods inventories.

Chart III
PRIVATE RESIDENTIAL CONSTRUCTION
Seasonally adjusted annual rates



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

PERSONAL INCOME, RESIDENTIAL CONSTRUCTION, AND RETAIL SALES

Personal income rose $6.7 billion in April, the largest increase thus far this year and just slightly below the $7 billion monthly rise averaged during 1974. Income in the private sector remained unchanged in the month, however, as a small increase in the payrolls of service industries was offset by a decline in income in the distributive industries. Manufacturing payrolls stabilized in April, after posting a small increase in March. Prior to this, manufacturing payrolls had been reduced considerably so that in April they were 7.4 percent below the peak of last October. Government payrolls, meanwhile, rose slightly as a result of expanded employment under public service job programs. Among nonwage earners, small gains were posted by all groups, with the rise in transfer payments especially modest in comparison with previous months. Finally, reflecting an increase in farm prices, income of farmers grew $1.7 billion in April but the advance still left farm income 38 percent lower than it was a year ago.

Weakness in residential construction persisted in April, as housing starts rose only modestly above the sluggish pace of the previous month (see Chart III). At 990,000 units in April, starts were 37 percent below the level of a year earlier. However, there are signs that a modest upturn in housing construction may soon begin. Thus far this year, housing starts have consistently been above last December's depressed level. Moreover, in April, newly issued building permits jumped 27 percent above those of March and were higher than at any time since last August. Also, there is some evidence that the recently passed tax credit for purchases of new homes built or under construction before the end of March is cutting into the inventory of unsold homes. The combination of an increase in sales and a reduction in the number of homes available for sale lowered the backlog to 10.6 months in March, well below the 11.7 months averaged over the previous six months. On the other hand, mortgage interest rates are still very high and, despite the large volume of funds flowing into thrift institutions, the cost of financing a new home is only slightly below what it was one year ago. In coming months the behavior of mortgage interest rates as well as the growth in real income and changes in housing prices will be important in determining the strength of the housing recovery.

Retail sales advanced $647 million in April, after slumping rather sharply in March. Of course, the dollar volume of sales has been quite volatile in the past months, and consumer spending in April was only a little above the level of last July. Expenditures on durable goods rose slightly during the month, but they were nevertheless well below the average of the initial quarter of 1975. The reason for this is that in January and February widespread clearance sales and the automobile industry's cash rebate program boosted sales substantially. Over the entire first quarter, domestic auto sales averaged 6.6 million units but, upon the termination of the rebate program, sales slumped to 5.7 million units in April. Although an improvement was evident in May, auto sales were still running well below the industry's expectations. Spending on nondurables increased by nearly $300 million in April to a level 8.5 percent above that of a year earlier.

PRICE DEVELOPMENTS

Prices moved up irregularly in the past few months, but further indications of an abatement in underlying inflationary pressures were evident. At the retail level, inflation accelerated in April largely because of a spurt in food prices. Wholesale prices rose more slowly in May than they had in the previous month, however, with the advance in industrial commodity prices being about in line with the moderate increases registered in previous months.

Consumer prices jumped at a 7.1 percent seasonally adjusted annual rate in April, nearly double the advance of the previous month. Nevertheless, retail prices have increased only 5.7 percent over the three-month period ended in April, the mildest three-month advance since the beginning of 1973. Food prices, which declined in each of the two preceding months, reversed course in April and rose at a 4.2 percent annual rate. At the same time, higher prices for used cars and power and fuel paced a 9 percent annual-rate advance in consumer nonfood commodity prices. Although this was a bit higher than the advance experienced over the first quarter of this year, it was less than the 13.4 percent rise recorded in 1974. Finally, prices of consumer services rose at a 6.6 percent annual rate in April. This increase was about equal to the rise in the last three months, and it was mainly attributable to higher prices for transportation and medical care.

After jumping sharply in April, wholesale prices rose at a 4.2 percent annual rate in May. These increases, which reversed a decline that began last December, were precipitated by large boosts in prices of farm products and processed foods and feeds. The 7.3 percent annual-rate advance in farm and food prices in May was led by an increase in prices for livestock and poultry. Although prices of meat and poultry are expected to continue rising through the summer months, further large increases in food prices may be tempered by the expectation of record feed grain crops. While adverse weather conditions initially delayed corn plantings, prospects still appear good for a record crop. Furthermore, according to the latest Department of Agriculture forecast, this year's wheat crop is expected to be even larger than last year's record.

Meanwhile, wholesale prices of industrial commodities, which are generally considered to be a more accurate barometer of inflationary pressures, continued to climb only modestly. In May, industrial wholesale prices edged up at a 2.1 percent annual rate and, excluding power and fuel, industrial commodity prices remained unchanged over the last three months. To a large extent, this moderation reflects the large decreases in prices of raw materials that occurred earlier in the year. More recently, spot prices of raw industrial commodities have started to fall again so that there may well be a further abatement in inflation. At later stages of fabrication, prices of intermediate materials declined in May for the first time in nearly two years, while the increase in consumer finished goods prices remained below the advance of the last six months.