The Business Situation

Evidence continues to accumulate that recessionary forces in the economy are dissipating. Indeed, the end of the worst postwar recession either is close at hand or already has occurred. The new composite index of leading indicators posted a substantial gain in May, following a very large rise in the preceding month and a small advance in March. In the past, this index has typically led upturns in general economic activity by only two months or so. Elimination of the remaining overhang of inventories would lay the groundwork for an economic recovery, and progress on this front also has been made lately. In April the book value of manufacturing and trade inventories plunged by $1.8 billion, exceeding the average decline recorded in the two previous months. Industrial production slipped a bit further in May; however, the output of consumer goods increased for the second consecutive month. New orders for durable goods rose strongly in May, as did retail sales. Housing starts have shown modest improvement, and inroads have been made lately in reducing the backlog of unsold homes. Total employment rose in June for the third successive month, and the unemployment rate declined to 8.6 percent of the civilian labor force, down from 9.2 percent in May. However, the decline in joblessness was probably the result of statistical problems and therefore is an overstatement of the improvement in labor market conditions.

Recent price trends have been generally encouraging. While fuel prices have increased rather sharply in the past few months, other prices seem to be leveling off. Consumer prices rose at only a 4.2 percent annual rate in May, with prices of nonfood commodities edging up at a 2.4 percent rate. This was the smallest such rise in twenty-two months, and it resulted entirely from higher prices for consumer power and fuel. Wholesale prices declined at a 1.7 percent annual rate in June, as prices of farm products and related items decreased at a 16.5 percent annual rate. Prices of industrial commodities rose at a faster rate than in the last several months. Despite this acceleration, underlying inflationary pressures remain moderate since more than half the 4.6 percent rise in industrial commodity prices in June was attributable to higher energy prices.

INDUSTRIAL PRODUCTION, LEADING INDICATORS, ORDERS, AND INVENTORIES

Industrial production declined for the eighth consecutive month in May (see Chart I), leaving output in the nation's factories, mines, and utilities 13 percent below the level attained last September. Including the modest 0.3 percent May slippage, the current slide in production now amounts to the longest sustained drop in seventeen years. Nonetheless, compared with the 8 percent contraction in production averaged in the first quarter of this year, the mildness of the declines in April and May seems to be pointing toward a bottoming-out of the current contraction. The decline in May resulted chiefly from a further fall in the production of business equipment and materials. Output of consumer goods, on the other hand, increased for the second successive month, as production of durable goods advanced sharply. Stepped-up production of automobiles accounted for most of the rise, although output of appliances and furniture also rose during the month. In June the output of passenger cars continued to increase to the highest level since last November.

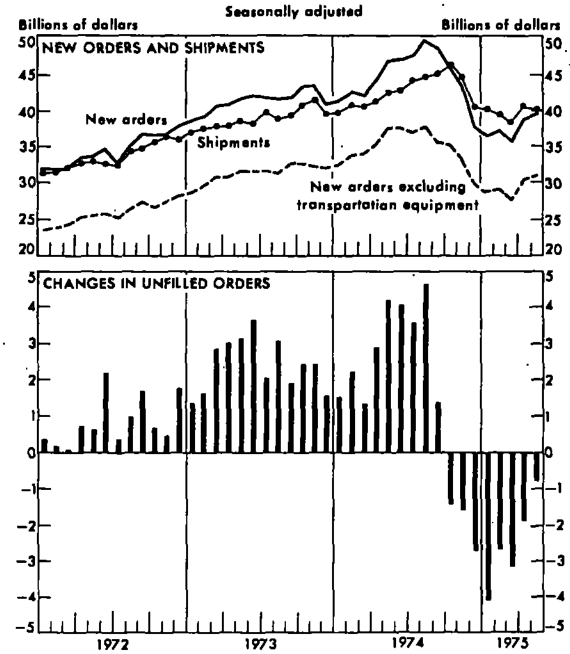
In May the Government's revised index of leading economic indicators rose 2.1 percent, a somewhat smaller increase than the advance posted in the previous month. The index currently stands at its highest level since last November, but it is still 25 percent below the peak registered in the middle of 1973. Nonetheless, the leading indicators have increased for three consecutive months, the most sustained advance since July 1973. In the past, a three-month rise after a sustained decline has invariably been followed by the end of a recession, so that the most recent increase strongly suggests the current economic downturn is ending. Of the ten indicators available for May, eight rose while the remaining two were unchanged.

New orders for durable goods rose $498 million in May, continuing an uptrend that initially surfaced last February (see Chart II). However, the rise was neither so large as the surge in April nor so broadly based. Much of the May increase was centered in orders for primary metals, while bookings for machinery and capital goods rose only moderately. Orders for household durable goods were essentially unchanged during May, as were bookings for transportation equipment. Shipments of durables declined during the month, but they still remained higher than the level of new orders. Consequently, the backlog of unfilled orders dropped for the eighth consecutive month.

The book value of total business inventories fell in April by $1.9 billion. This decline was slightly more than that recorded in the preceding month, and it marks the first time since 1961 that stocks have fallen for three consecutive months. Business sales, meanwhile, climbed 2.1 percent in April, after falling in four of the five previous months. Consequently, the ratio of inventories to sales equaled 1.65 months in April, down from 1.7 months in March. At this level, the stock-sales ratio in April was at its lowest reading since last November though still well above the 1.46 months of sales reached one year ago.

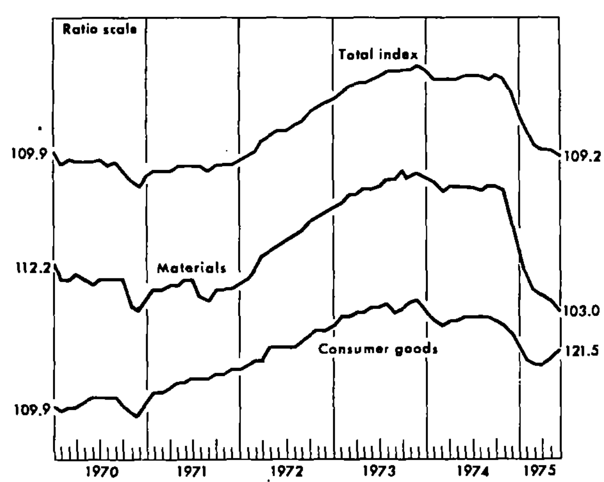
The accelerating pace of inventory liquidation was fairly widespread. In April, inventories held by manufacturers fell $1 billion, and in May the reduction was even larger. At the wholesale level, stocks fell by about $0.5 billion in April, which was well above the decumulation averaged in the previous three months. Retailers, on the other hand, worked off inventories at only a fraction of the rate recorded earlier in the year. Stocks of nondurable goods at retail outlets were liquidated at a rapid rate, but inventories of durable goods, which dropped sharply in the January-March period, were essentially unchanged in April because of a renewed buildup in stocks of unsold automobiles.

Chart II
ORDERS AND SHIPMENTS OF MANUFACTURED DURABLE GOODS
Seasonally adjusted



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

Chart I
INDUSTRIAL PRODUCTION
Seasonally adjusted; 1967=100



Source: Board of Governors of the Federal Reserve System.

PERSONAL INCOME, CONSUMER DEMAND, AND RESIDENTIAL CONSTRUCTION

Personal income rose $9.3 billion in May, as both public and private sector payrolls expanded. The increase was the largest since last September and, coupled with the distribution of tax rebates and lower withholding rates, may provide a boost to consumer spending. Government payrolls rose modestly in May, but private sector wage and salary disbursements increased by a hefty $3.4 billion. Virtually all of this was concentrated in the service and distribution industries. Manufacturing payrolls edged up only slightly in May, remaining well below the level of last January. Moreover, this small increase was centered in expanded payrolls of nondurable goods producers, as wage and salary outlays of durable goods producers continued to contract.

Consumer demand at retail outlets climbed 2.2 percent in May, as expenditures on both durable and nondurable goods registered impressive gains. Current-dollar sales have increased in five of the last six months, with the most recent advance the largest in percentage terms since January. Spending on durable goods rose $377 million in May primarily because of higher outlays for automobiles. Although passenger car sales are still depressed, demand has slowly but steadily picked up in recent months. Auto sales jumped 8.8 percent to 6.2 million units in May and, in June, sales rose to the highest level since February. Finally, spending on nondurables jumped by more than $600 million in May, the sharpest monthly advance in nearly two years.

The housing picture also appears to have brightened in May. Housing starts rose 14 percent in May to a seasonally adjusted 1.1 million units, the highest level in eight months. Moreover, newly issued building permits rose for the second consecutive month in May and are now higher than at any time since last August. But, while a housing recovery seems to be in progress, residential construction activity has been extremely weak and the number of housing starts in May was 23 percent below the year-earlier level. However, the upturn may strengthen somewhat in coming months, since the volume of unsold homes has been reduced sharply. In April, sales of new single-family homes jumped 25 percent as the recently passed tax credit for new-home purchases went into effect. Combined with a further reduction in the number of homes available for sale, the backlog fell to 8.1 months in April, the lowest level in almost two years.

PRICE DEVELOPMENTS

Consumer prices rose at a 4.2 percent seasonally adjusted annual rate in May, as the rate of price increase of nonfood commodities and services moderated considerably. Over the three months ended in May, retail prices advanced at a 4.9 percent annual rate, the smallest three-month rise since the period ended January 1973. Nonfood commodity prices edged up at only a 2.4 percent annual rate in May, the smallest increase in twenty-two months. Consumer energy prices rose sharply in May, however, and, if these are excluded, nonfood commodity prices were unchanged in the month. Meanwhile, increases in the cost of medical care and rents pushed prices of services up at a 2.9 percent annual rate in May, the smallest advance in nearly two years. Food prices, on the other hand, have started to increase more rapidly. In May, retail food prices rose at a 6.3 percent annual rate, a somewhat more rapid rate than in April. This acceleration, which was attributable to large hikes in prices of meats and poultry, was not surprising in light of recent movements in farm prices at the wholesale level.

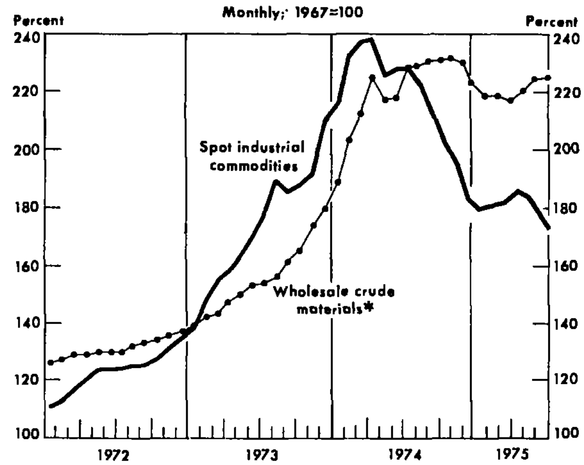
Wholesale prices declined at a seasonally adjusted 1.7 percent annual rate in June, after rising in each of the previous two months. The easing in prices was due entirely to a 16.5 percent annual-rate decline in prices of farm products and processed foods and feeds. Prices of livestock and poultry continued rising in June, but these increases were offset by fairly large declines in prices of the major feed grains. Industrial commodity prices advanced at a 4.6 percent annual rate in June, somewhat faster than in the last few months. Nevertheless, this does not appear to signal a broad resurgence in inflationary pressures since the acceleration mainly reflected higher energy prices. Indeed, industrial commodity prices excluding power and fuel rose at only a 2.2 percent annual rate in June. Increases in energy prices also contributed significantly to a 6.4 percent rise in crude material prices in that month. Since energy prices began rising again rapidly three months ago, wholesale prices of crude materials have jumped at a 14.1 percent annual rate.

Movements in crude material prices typically parallel changes in spot prices of industrial commodities. For example, beginning in 1972 and extending through four months of 1974, the run-up in commodity prices was matched by sharp increases in prices of crude materials (see Chart III). Dramatic increases in scrap metal prices were principally responsible for this commodity price

Chart III

PRICES OF INDUSTRIAL MATERIALS

Monthly; 1967=100



* Seasonally adjusted.

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

spiral. The spot metals index, which accounts for approximately one half of the entire industrial spot price index, rose more than 80 percent from the middle of 1973 to mid-1974. This was characterized by nearly a threefold increase in the price of scrap steel as well as significant increases in the prices of other metals. Prices of textiles and other raw industrial commodities, meanwhile, rose only modestly. By May of last year, market pressures began softening somewhat, and spot prices started falling, while the rise in crude material prices leveled off. Since November both series generally have moved together, but in May and June industrial spot prices fell while prices of crude materials spurted somewhat.

There are several factors which account for much of the discrepancy in these movements. Unlike wholesale prices, spot market prices are not seasonally adjusted. Also, the various commodities included in the spot market index are equally important, while the relative importance of each wholesale crude material commodity varies. Indeed, scrap metal prices amount to only about 20 percent of the wholesale price index for crude materials but nearly one half of the spot price index. Thus, if metal prices are rising or falling very rapidly while other prices are registering small changes, the spot price index will be affected more than wholesale crude materials.

More broadly, it should be emphasized that the composition of the two series differs. In particular, prices of crude petroleum and bituminous coal are excluded from the spot price index but are part of the wholesale crude materials index. Conversely, prices of textiles are included in the spot market index, but they do not appear in the index for wholesale crude materials. These differences became very significant beginning in the summer of 1974, when a huge gap in the two measures opened up. A plunge in metal prices and a moderate drop in prices of textiles pushed spot prices down sharply. However, a similar decline in wholesale crude material prices was prevented by sharp increases in energy prices. More recently, further increases in energy prices have again caused spot and wholesale prices to move in opposite directions. In fact, a rise in energy prices accounts for most of the increase in prices of crude materials during May. If energy prices are excluded, crude material prices barely changed at all in that month. Hence, the rise in prices of crude materials does not alter the fact that inflationary pressures are moderating. Certainly the recent movement in industrial spot prices suggests that the market for most basic commodities is still rather weak.

LABOR MARKET DEVELOPMENTS

Unemployment declined to 8.6 percent of the civilian labor force in June, after reaching 9.2 percent in the preceding month. This was the first drop in more than one year, and the jobless rate is now the lowest since February. Whether this does in fact mark a definite improvement in labor market conditions is questionable, though, since the unemployment rate has been distorted by faulty seasonal adjustment procedures in the last two months. Subsequent revision will probably show that the jobless figures initially reported were too high in May and too low in June. Nevertheless, the total number of employed persons did rise again in June, although not by as much as in May, and most of the major categories of workers experienced lower unemployment in June. On the other hand, the percentage of those unemployed for more than fifteen weeks rose to 3.1 percent of the civilian labor force, the highest since the series began in 1948.

The separate survey of nonfarm establishments suggests that the labor picture was essentially unchanged in June. Total payroll employment edged up slightly during the month, as payrolls in the trade, finance, and services industries all increased. Government payrolls also expanded slightly in June, but this may not persist in light of recent budget cutbacks among states and localities. Meanwhile, the number of employees in construction fell by 52,000 persons in June. Manufacturing employment also declined slightly, after rising in May. The drop in June, however, was not nearly so large as the declines in manufacturing payrolls registered earlier in the year.