The Business Situation

Economic activity has continued to expand, but at a slower pace than that of 1972 and early 1973.* However, the ability of the economy to maintain upward momentum has come to depend to an uncertain degree upon the magnitude and economic impact of the energy shortage. The size of the prospective shortage, severely exacerbated by the Mideast oil embargo, has been subject to widely divergent estimates based on different assumptions about the availability of alternative petroleum supplies, the substitution possibilities among existing energy sources, and the severity of winter weather. Moreover, the economic consequences of whatever shortfall in energy supplies materializes have proved difficult to ascertain because of uncertainty both as to just how the overall shortfall will impact on the various economic sectors and regions and as to how productive capacity will be affected by the pattern of reductions that does emerge. As a result, quantitative estimates of possible economic repercussions have differed greatly.

The effects of the oil embargo have yet to be widely registered in available economic data because petroleum deliveries from the Mideast had not come to a halt at the time when most of the information was gathered. During October, industrial production and new orders for durable goods increased substantially. However, residential construction continued to contract, and business inventory accumulation remains surprisingly weak when the impact of rapidly rising prices is stripped away. Retail sales remained essentially unchanged in November, continuing the erratic and relatively slow growth over the past eight months. The energy problem has weighed heavily on the stock market, where prices have fallen precipitously since the beginning of November. Moreover, planned automobile production has been reduced because of the drop in sales, related at least in part to concern over the availability and cost of fuel.

The pervasive role of petroleum products in overall industrial production implies that fuel price increases may intensify the strong inflationary pressures already in prospect for the months ahead. The consumer price index rose at a very rapid annual rate of close to 10 percent in October. Wholesale prices for November are among the first of the economic barometers to be affected by the oil embargo. Propelled by rising fuel costs, wholesale prices jumped at a 21 percent annual rate despite another drop in farm prices. Unemployment was 4.7 percent in November, up from the October rate of 4.5 percent but about the same as the average of the past few months. Given the timing of the data collection, the November labor market statistics were not affected by the shortage of oil.

PERSONAL INCOME, CONSUMER DEMAND, AND RESIDENTIAL CONSTRUCTION

Personal income climbed $9.2 billion in October to a seasonally adjusted annual rate of $1,067.7 billion, following an even more substantial rise the previous month. All of the major categories of personal income increased in October, with the exception of farm proprietors' income; nevertheless, farm income soared 36 percent over the year ended in October. The pay raise for Federal civilian and military employees, which the President sought unsuccessfully to delay until December, amounted to about $1½ billion of the October increase in personal income. Over the first ten months of 1973, personal income has advanced at an annual rate of 10.3 percent, about the same rate of expansion as that experienced in 1972. Of course, accelerating inflation has considerably slowed the gain in real income this year. The consumer price index has climbed at nearly a 9 percent annual rate over the first ten months of 1973, up sharply from the 3.4 percent increase of 1972.

According to the preliminary estimate, retail sales flat-

* The estimate of third-quarter gross national product (GNP) growth has been revised upward slightly from $32 billion to $32.5 billion. Real GNP is now estimated to have grown at a 3.4 percent annual rate, a bit below the preliminary estimate. The annual rate of increase in the GNP price deflator was raised slightly to 7 percent. The estimate of inventory investment was reduced by $4 billion, while the estimate of net exports of goods and services was raised by $3.6 billion to $7.6 billion. Although preliminary estimates of pretax corporate profits rose slightly, after-tax profits fell by $100 million to a seasonally adjusted annual rate of $71.5 billion in the third quarter.

tened out in November when a modest increase in nondurables was offset by a small decline in spending at durables stores. Over the past eight months, retail sales have risen at a slow annual rate of 4 percent, compared with the very rapid rise of 19 percent in the preceding eight months. The slowdown is even more pronounced if allowance is made for a more rapid rate of inflation in the recent period. Not only has the overall growth of retail sales slowed, but the composition has changed dramatically. Although rising more slowly than before, nondurables have provided most of the momentum. Since March, sales volume at automotive outlets has declined at about a 7 percent annual rate, after rising at a 28 percent annual rate in the previous eight months. During the more recent period, nonautomotive durables have edged up at a 2 percent annual rate, only a fraction of the 23 percent climb recorded over the eight months ended this past March.

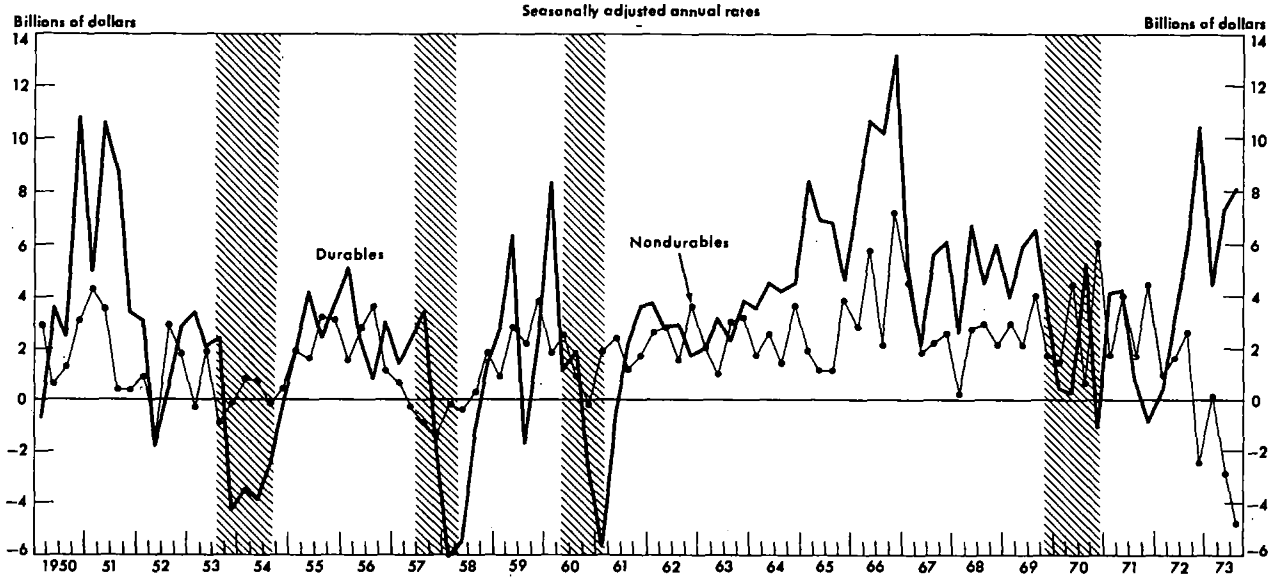
Automobile sales have moderated in recent months in response to a combination of factors affecting supply and demand. Work stoppages and parts shortages have intermittently slowed production, thus restraining supply. The demand for new cars has softened as a result of uncertainty about the effects of the energy shortage on the economy, concern with the rising price and the declining availability of gasoline, and widespread purchasing earlier in the year to avoid paying for the required antipollution and safety devices on 1974 models. Indeed, there has been a dramatic shift in the composition of demand toward smaller, more economical models. In both October and November, seasonally adjusted sales of new domestically produced passenger cars were at an 8.7 million unit annual rate, down from the 10.1 million unit pace averaged over the first nine months of the year. Some slowing in the rate of new car sales was widely anticipated even before the 1974 models were launched, but the current pace is probably slower than expected.

Residential construction has continued to retreat from the high levels experienced throughout 1972 and earlier this year. The contraction in housing activity reflects to a considerable extent the tightness of mortgage credit, although some decline in the previous unsustainable pace of expansion would have occurred in any event. In October, housing starts dropped to an annual rate of 1.61 million units, the lowest in three years and well below the year-earlier rate of 2.45 million units. Over the year ended in October, starts of multifamily structures fell

Chart I

NONFARM INVENTORY INVESTMENT IN THE GNP ACCOUNTS

Seasonally adjusted annual rates



Note: Shaded areas represent recession periods, according to the National Bureau of Economic Research chronology. The dates of the 1969-70 recession are tentative.

Source: United States Department of Commerce, Bureau of Economic Analysis.

sharply; such starts decreased 41 percent, compared with the 28 percent decline for single-family dwellings. On a regional basis since October 1972, starts have dropped most in percentage terms in the South, least in the north central states, and by about the same magnitude in the Northeast and the West.

Deliveries of mobile homes have also slowed abruptly from a record seasonally adjusted annual rate of 740,000 units this past March to 470,000 units in September. Sales of new one-family homes edged up slightly in September, while inventories of unsold single-family homes moved down to 9.8 months of sales, a bit lower than the August ratio but still substantially higher than any other month on record. Further confirmation of the slack in the residential construction sector comes from evidence on the amount of time it takes a new one-family home to be sold from the start of construction. During the third quarter, a median of 4.4 months (seasonally adjusted) elapsed from groundbreaking to sale. This is below the median of 4.8 months posted over the second quarter but is still well above the 3.1 months "for sale" time averaged in 1972.

INDUSTRIAL PRODUCTION, INVENTORIES, AND ORDERS

The Federal Reserve Board's index of industrial production, which measures the physical output of the nation's factories, mines, and utilities, rose at a 6.6 percent seasonally adjusted annual rate in October. This increase is in keeping with the slower growth in output that characterized the second and third quarters when output rose at a 5½ percent annual rate, about half as fast as in the preceding year.

Gains in production in October were registered in all major categories, with the notable exception of a decline in industrial materials output at a 2.7 percent annual rate. This was the first drop in materials output in about two years. Production of motor vehicles and parts registered its second consecutive monthly gain after falling sharply in August because of a variety of production difficulties, including parts shortages for the 1974 automobiles. Passenger car production was at a 9.4 million unit pace in October, below the record 10.3 million unit rate of July. Production rose to 9.6 million units in November, but it is unlikely that this pace will be maintained during the next few months, given the trimming of assembly schedules recently announced by the three major producers of automobiles. The precise impact of the announced plant closings on industrial output depends on the extent to which the shutdowns are only temporary and reflect a reorientation of productive capabilities toward the production of smaller cars.

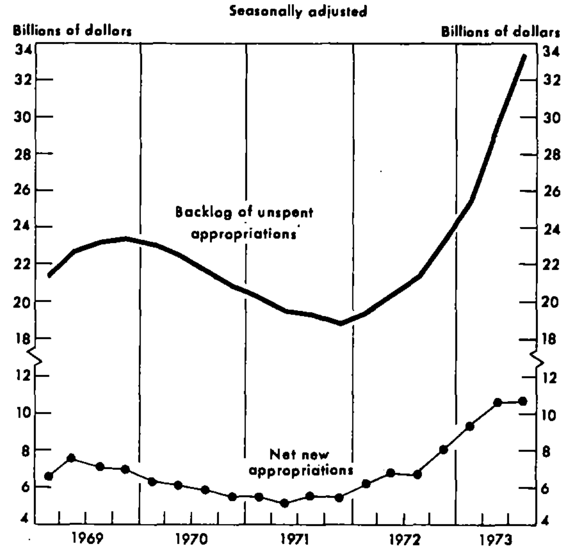
The energy category of industrial production, which includes electric power and gas utilities and petroleum refining, accounts for a sizable 11.2 percent of the total index. Energy output rose at an annual rate of 4½ percent in October, as it was apparently too early for the boycott on oil shipments to the United States to have any pronounced effects. Over the year ended in October, energy production grew 4.2 percent, considerably slower than the 7.2 percent rise of total industrial output. Over the longer period spanning the past ten years, energy production and overall industrial production have increased at about the same rate of 5 percent per year.

Inventory accumulation has remained surprisingly sluggish throughout 1973. The third-quarter change in business inventories reported in the GNP accounts was revised down to a weak $4.7 billion. Inventory investment during the first three quarters of 1973 has averaged about $4½ billion per quarter, substantially below the $8½ billion rate of accumulation averaged during the second half of last year. On the other hand, increases in the book value of total business inventories have tended to be considerably stronger in 1973 than during the previous year. For example, the book value of inventories rose at an annual rate of about $21 billion in the first nine months of this year, which is about 50 percent faster than the rise experienced over the second half of 1972. This marked discrepancy between inventory gains on a book value basis and in the national income accounts is explained by the impact of rapidly rising prices. Inflation generates inventory capital gains, which boost changes in the book value of inventories. However, the GNP accounts, anchored in the concept of current production, record changes in physical stocks only.

The recent sluggishness of inventory spending on a national income accounts basis stems largely from the dramatic and persistent weakening of nondurables inventory investment over the past year (see Chart I). In previous business expansions, nondurable stocks rose relative to their recession levels. Durables inventories, while more in keeping with past cyclical patterns, are also quite lean, as indicated by the fact that the ratio of inventory book value to sales is at its lowest level since 1965.

New orders placed with manufacturers of durable goods rose in October by a substantial $1.7 billion after declining in the three previous months. The advance was mainly in orders for primary metals, machinery, and transportation equipment. Orders placed for nondefense capital goods increased in both September and October and currently stand just a shade below the record June level. In the first ten months of 1973, durables bookings have expanded at around an 18 percent annual rate, after increasing almost 23 percent in 1972. Because durable goods prices have

Chart II
CAPITAL APPROPRIATIONS IN MANUFACTURING
Seasonally adjusted



Source: The Conference Board, Inc.

been accelerating more rapidly in 1973, the above comparison understates the slowdown in the expansion of real bookings relative to last year. This slower rise may in part reflect supply factors. Long delivery lead times, high rates of capacity utilization, and huge orders backlogs suggest that many industries are close to being booked to capacity.

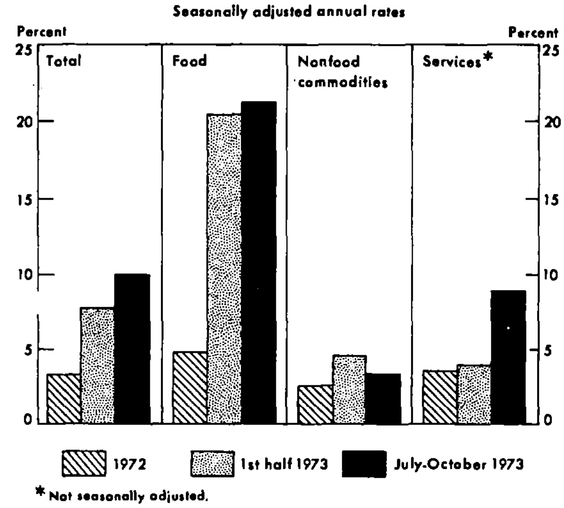
The backlog of unfilled orders for manufacturers' durable goods continued to mount in October, reaching a level that was about 35 percent higher than a year earlier. While the ratio of durables manufacturers' unfilled orders to shipments moved down slightly to 2.58 in October, it is still substantially higher than the ratio of a year ago.

The presence of sizable orders backlogs has probably bolstered business plans to expand capacity in 1974. Based on its most recent survey, McGraw-Hill reports a 14 percent planned increase in new plant and equipment spending in 1974. This is comparable to the 12 percent planned rise estimated by Lionel D. Edie & Company Inc. and the 15 percent increase cited by Rinfret-Boston for 1974. The Commerce Department's first readings project business fixed investment to climb at about a 13.3 percent annual rate over the first half of 1974. Respondents to the McGraw-Hill survey anticipated a 7 percent rise in plant and equipment prices together with an increase of 7 percent in real outlays. In the manufacturing sector, capital spending is projected to climb by a very substantial 24 percent next year. The Conference Board's survey of the 1,000 largest manufacturing firms reports that net new capital appropriations climbed by about $0.2 billion to $10.6 billion in the third quarter, compared with an average $6.9 billion in 1972. The backlog of appropriated but unspent funds reached $33.3 billion, up $12 billion from a year earlier (see Chart II). Even if the growth of new appropriations slows in coming quarters, the huge backlog of appropriated but unspent funds could serve to maintain a high rate of capital spending. The surveys were taken prior to the oil embargo, and the effect of the energy situation on the magnitude and direction of change in overall investment is uncertain. Shortages of petroleum-related inputs may postpone some projects, but capital expenditures in energy-producing industries could exceed previous estimates.

RECENT PRICE DEVELOPMENTS

There are not as yet any signs of a fundamental diminution in inflation. In October, the consumer price index rose at a very rapid seasonally adjusted annual rate of 9.9 percent. Month-to-month fluctuations in the price data have been affected by changes in the Economic Stabilization Program and may therefore be misleading. However, over the four months ended in October, consumer prices rose at a 10 percent annual rate, faster than the 7.8 percent rise of the first half of the year and much more

Chart III
CHANGES IN CONSUMER PRICES
Seasonally adjusted annual rates



* Not seasonally adjusted.
Source: United States Department of Labor, Bureau of Labor Statistics.

rapidly than the 3.4 percent increase during 1972 (see Chart III). Since October 1972, consumer prices have jumped 7.9 percent, marking the largest twelve-month climb since the Korean war period.

A major contributor to the overall rise in consumer prices in October was the surge in prices of services, which climbed at a 13.7 percent annual rate, the largest monthly increase on record. The October climb was paced by another large increase in home-mortgage costs and by the once-a-year adjustment of medical care costs. Even apart from these factors, the rise in the price of services was substantial. Consumer food prices, which had fallen slightly in September, rose at a 6.5 percent annual rate in October, bringing the increase in food prices over the July-October period to 21.3 percent, about the same as the 20.4 percent burst of the first half of the year. Meat, poultry, and egg prices fell in October, but this was offset by rising prices of most other major components of the food-at-home index and higher prices for food away from home.

Prices of nonfood commodities rose at a 5.8 percent annual rate in October. Over one third of the increase in nonfood commodities prices stemmed from higher costs of gasoline and fuel oil. It should be noted that the October price data were gathered largely before the start of the Arab boycott of oil shipments to the United States. Strong demand has put substantial upward pressure on energy prices for some time. For example, fuel oil and coal prices soared almost 20 percent during the year ended in October and gasoline and motor oil prices rose 10 percent. Gasoline and oil prices carry a weight of less than 4 percent in the overall consumer price index. However, further price increases, either through the imposition of excise taxes or rising market prices, will certainly have a broader impact on consumer prices than is suggested by the weight of the component because of the pervasive role of fuel in the production of the items included in the index.

Wholesale prices jumped by a very large 21.1 percent seasonally adjusted annual rate in November, as soaring energy prices swamped another decline in agricultural prices. The fuel and power category, which has a weight of 7 percent in the overall wholesale price index and 10 percent in the closely watched industrial commodities component, exploded at a 19.3 percent monthly rate—a 232 percent annual rate—in the face of the Arab oil embargo. At the same time, the Cost of Living Council has modified its regulations pertaining to price increases for petroleum products. Even when fuel and power are excluded, prices of wholesale industrial commodities climbed at a 13 percent annual rate, up from 9.4 percent in October and 8 percent over the first nine months of this year. Prices of farm products and processed foods and feeds fell 17.7 percent at an annual rate in November for their third consecutive monthly decline, but were still 31.2 percent higher than a year ago.

WAGES AND EMPLOYMENT

Although wages are rising rather modestly by comparison with the very rapid climb in the cost of living, they have nonetheless stepped up their rate of growth. According to preliminary data, the hourly earnings index for private nonfarm production workers—which is adjusted for the effects of interindustry employment shifts and manufacturing overtime—rose at a slow 3.2 percent seasonally adjusted annual rate in November. Changes in the index are somewhat volatile on a month-to-month basis; it is helpful to examine longer time spans for signs of emerging trends. Over the past six months, basic wage rates as approximated by the index have climbed at a 7.5 percent annual rate, noticeably faster than the 5.8 percent rise of the preceding half year.

On balance, the mixture of data gathered in November suggest that no sudden change in labor market conditions took place during the month. It is important to note that, given the timing of the data collection, the Arab oil embargo had little or no effect on these particular statistics. According to the household survey, seasonally adjusted employment was essentially unchanged following the very large gains recorded during each of the preceding two months. During the past year, employment has expanded by a vigorous 3.8 percent, compared with the gain of 3.2 percent during the twelve months ended in November 1972. While small, the growth of the labor force during November was large enough to push the unemployment rate up by 0.2 percentage points to 4.7 percent, which is the average for the preceding four months.

In the separate November survey of nonfarm establishments, seasonally adjusted employment rose by around 200,000 workers, a bit less than the average monthly gain posted over the first ten months of the year. Because of differences in coverage, sampling techniques, and seasonal patterns, the payroll and household surveys often diverge on a monthly basis but tend to show comparable changes over somewhat longer periods of time. Manufacturing employment went up by around 50,000, less than half the October gain but a little above the rate averaged over the second and third quarters. Although November employment increased, both the average workweek and overtime hours for manufacturing production workers remained unchanged at levels well below the recent peaks recorded earlier in 1973.