The Business Situation

The economy has continued noticeably less buoyant in recent months than in the early part of 1973. More subdued consumer demand, capacity limitations, and supply bottlenecks have all contributed to the slower rate of economic expansion. As the effects of the embargo on Arabian oil exports to the United States begin to make themselves felt, the productive capacity of the economy will be further constrained. Although Administration estimates of the petroleum shortage during the next few months have been revised downward, the projected shortfall is still large and its impact on the economy remains uncertain. Much depends on the duration of the embargo, the extent to which nonessential energy consumption can be curtailed, and the overall efficacy of the Government's oil allocation program.

The latest available data on the business situation cover a period when there was still little adverse effect from the Mideast oil embargo—aside from that on prices and automobile sales. Industrial production increased only slightly in November, with the magnitude of the gain as well as of those in the two previous months considerably smaller than the advances recorded earlier. The less rapid growth in production in recent months has been, to a considerable extent, the result of capacity limitations and shortages of materials, as evidenced by the high backlog of unfilled orders and the unusually lengthy lead times between orders and deliveries. However, the less vigorous demand for consumer durables has also contributed to the slower growth. This ebbing in demand for consumer durables, especially noticeable with regard to automobiles, resulted in the advance estimates of retail sales for November remaining virtually unchanged, even before making allowance for rising prices. New car sales declined further during December, owing partly to a rapid shift in demand for gas-economizing models, which were not available in sufficient number. The housing slump remained quite evident in November, despite a small rise in starts. Unemployment rose to 4.9 percent of the labor force in December, the second straight monthly increase from the 3½-year low of 4.5 percent reached in October. The December data were gathered too early to have been significantly affected by the oil embargo.

The price situation reflects widespread upward pressures, with no relief in sight. In November, the consumer price index was rising at an annual rate of around 9½ percent. Soaring prices of gasoline, motor oil, fuel, and utilities, along with large increases for food commodities, accounted for much of the jump. In December, the wholesale price index surged at an annual rate of over 26 percent, seasonally adjusted. The increases were particularly large for fuels and power, but they were also very sizable for other industrial commodities and for farm products.

INDUSTRIAL PRODUCTION, ORDERS, AND INVENTORIES

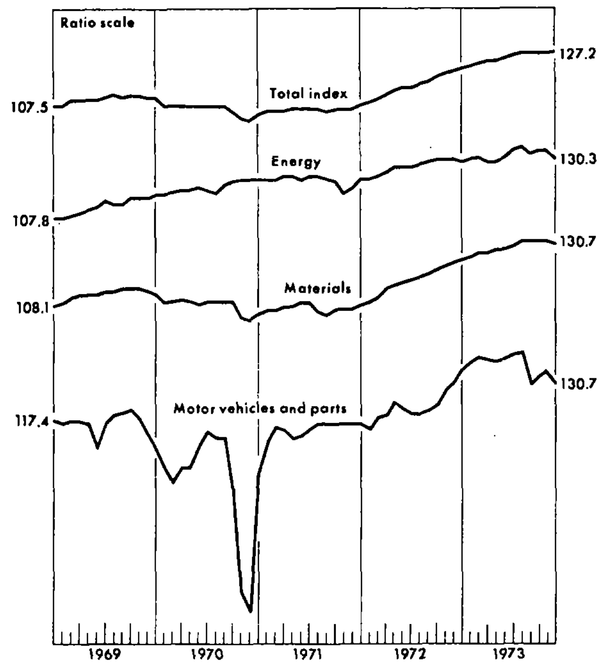
The Federal Reserve Board's index of industrial production, seasonally adjusted, posted a modest 2 percent annual rate of advance in November. By comparison, this measure of the output of the nation's factories, mines, and utilities had increased at a 3.3 percent annual rate in the previous four months, at a 7.4 percent annual rate during the first half of the year, and at a 12 percent rate during 1972.

Decreases in the production of energy, materials, and automotive products contributed to the stunting of the November advance in the overall index (see Chart I). The energy component encompasses the fuel extractive industries, the gas and electric utilities, and the petroleum- and coke-refining industries. Crude oil deliveries from the Mideast had not been unduly interrupted in November; the decline in energy production reflected, rather, a marked cutback in electricity consumption, apparently because of conservation measures as well as the unusually mild weather. Widespread shortages of raw materials seem to have been mainly responsible for the slight dip in the production of materials. In recent months, capacity limitations that have prevented further expansion of output by ma-

Chart I

INDUSTRIAL PRODUCTION

Seasonally adjusted; 1967=100



Source: Board of Governors of the Federal Reserve System.

terials producers have constituted bottlenecks for the rest of the economy, severely limiting the overall rate of economic expansion. The developing energy shortage is likely to exacerbate this situation in coming months. At present, however, it is the automotive industry that has been most affected by the uncertainties engendered by the oil embargo. Although declines in truck, bus, and parts output accounted for the big November drop in the production of motor vehicles and parts, a weakening in demand for passenger cars has been very apparent. While auto assemblies rose to a 9.6 million unit pace in November, they fell to an 8.2 million unit rate in December according to preliminary estimates. The temporary closing of a number of automobile assembly plants, in part to reorient production toward the smaller-sized models, will serve to hold down production in the near-term future as well.

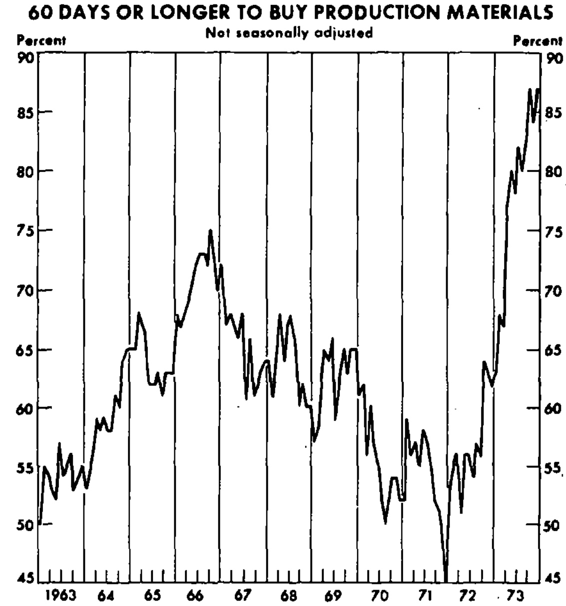
In November, the seasonally adjusted flow of new orders received by durable goods manufacturers rose by $400 million, less than one fourth of the spurt of the previous month. The November gain, attributable mainly to enlarged bookings for nondefense capital goods, amounted to a 10.7 percent annual rate of increase. In the year ended May 1973, new bookings had expanded 25 percent. Between May and October of this year, however, the annual growth rate slowed to 9 percent. Moreover, much of the increase since May has centered in orders placed for capital goods, defense as well as nondefense items. Indeed, excluding nondefense and volatile defense capital goods orders, the growth rate in new bookings amounted to 25.9 percent for the year ended May 1973 and to only a 4.6 percent annual rate for the May-November period.

Despite the recent slowing in orders and continuing additions to capacity, the lag between the placement and the delivery of orders still is unusually long. In November, the increment to the backlog of unfilled durables orders amounted to $2.5 billion on a seasonally adjusted basis, about the same as the increase averaged in the first ten months of the year. The ratio of unfilled durables orders to sales rose to 2.62, the highest level in recent years. Data gathered from other sources also suggest that the delivery lag is still lengthy. For example, the National Association of Purchasing Management's survey for December showed that the percentage of its respondents reporting commitments of at least sixty days to buy production materials was

Chart II

PERCENTAGE OF COMPANIES REPORTING COMMITMENTS OF 60 DAYS OR LONGER TO BUY PRODUCTION MATERIALS

Not seasonally adjusted



Source: National Association of Purchasing Management, Inc.

again at its post-Korean-war high, initially reached in October (see Chart II).

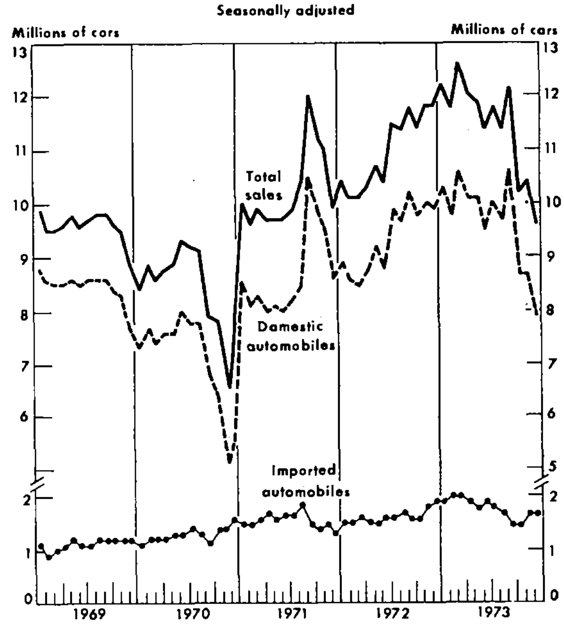
Throughout the first ten months of the year, the book value of total business inventories has grown at a rate about double that of 1972. Much of this acceleration, however, reflects the faster pace of inflation rather than a buildup of physical stocks. Because business sales are affected by inflation in much the same way as the book value of inventories, the inventory-to-sales ratio tends to be a more accurate indicator of inventory conditions than the change in inventories alone. In past business expansions, the inventory-to-sales ratio fell during periods of rapid real growth and started to climb when growth slowed, as growth has over the second and third quarters of 1973. The ratio declined to a post-Korean-war low of 1.41 this past July, hesitantly rose in the next two months, but then fell back to the July level in October, the latest month for which data are available. Widespread shortages of materials have been in part responsible for businesses being unable to build up desired buffer stocks of inventories.

In November, the book value of manufacturers' inventories rose at a $13.4 billion seasonally adjusted annual rate, about the same as the gain in the previous month but somewhat above the pace recorded during the first nine months of 1973. A fairly rapid increase in shipments resulted in a trimming of the manufacturing inventory-sales ratio to 1.54, a post-Korean-war low. While the stock-sales ratio for durables remained essentially unchanged, the ratio for nondurables sank to 1.16, the lowest reading on record.

Chart III

AUTOMOBILE SALES

Seasonally adjusted



Sources: Domestic automobile sales: Board of Governors of the Federal Reserve System; imported automobile sales: United States Department of Commerce, Bureau of Economic Analysis.

PERSONAL INCOME, CONSUMER DEMAND, AND RESIDENTIAL CONSTRUCTION

Personal income advanced in November at a seasonally adjusted annual rate of $8.7 billion, off slightly from the $9 billion gain of the previous month. Though sizable, the recent increase marked the third consecutive month that the rate of growth in personal income has slowed. The November rise was diffused across all the major income categories. Wage and salary disbursements expanded at a $5.6 billion pace, similar to the monthly gain averaged during the first ten months of 1973. Over the twelve months ended November, personal income grew by about 10 percent, slightly less than the gain recorded during 1972. The slowdown in real personal income has been larger as a result of accelerating inflation.

Prior to the Arab oil embargo, automobile sales had been expected to moderate from the hectic and presumably unsustainable pace of earlier this year. With the imposition of the oil embargo, the decline in automobile sales has been even severer than had been anticipated. In response to the sudden and unexpected changes in gasoline cost and availability, both the level and the composition of demand for autos have been markedly altered. Retail sales of large cars have fallen substantially, while sales of smaller, gas-economizing models have gone up. During December, sales of domestic cars declined to a seasonally adjusted annual rate of 7.9 million units. This was well below the rate of 10 million units averaged over the first three quarters of the year (see Chart III). The decline reflects both a fall in the total demand for new cars and a shift in the composition of demand toward smaller domestic and foreign models, which are in short supply.

Activity in the housing sector is continuing at much the same sluggish pace as during the past few months. Throughout this period, the mortgage market has remained tight. Housing starts in November were running at a 1.7 million unit seasonally adjusted annual rate, up slightly from the previous month but substantially below the 2¼ million unit rate posted in the eight months preceding the large September decline. Over the past three months, single-family and multifamily starts have been about 25 percent below their respective average monthly rates during the first half of 1973. Building permits continued the steady decline that began in the second half of the year, and by November stood at 1.3 million units, down only slightly from the previous month but 0.8 million units below the monthly average of the first half of the year.

Sales of new one-family homes declined in October to 523,000 units, down 26 percent from the first-half average and the lowest monthly figure in over three years. The sluggish October sales rate sent the inventories of unsold one-family homes to a record 10.7 months of sales, measured by the October level. Mobile-home sales fell for the third consecutive month, amounting in October to 444,000 units, 19.4 percent less than a year earlier and the slowest pace since March 1971.

PRICES

Inflationary pressures were undiminished in November, as the consumer price index rose at the extraordinarily high seasonally adjusted annual rate of 9.4 percent. Over the first eleven months of the year, consumer prices increased at a 9 percent annual rate, more than double the rate of growth that occurred in 1972. Much of the large November advance was attributable to the skyrocketing prices of energy items and to the resurgence of food price increases. The rise in the prices of nonenergy, nonfood consumer commodities was quite modest.

The enormous hikes in the prices of energy-related items accounted for about one third of the November advance in consumer prices. Recent decisions by the Cost of Living Council have allowed retailers to pass on higher wholesale costs of many refined petroleum products. Fuel oil and coal prices jumped at a 10 percent seasonally adjusted monthly rate, gasoline and motor oil prices rose 4.5 percent, and the increase in gas and electricity rates amounted to 1 percent. Further advances in energy prices are in the offing as a result of the intensifying effects of the Arabian countries' continuing embargo of oil to the United States and the steep increases in prices posted by members of the Organization of Petroleum Exporting Countries as well as by other oil-exporting nations. The combination of energy-related shortages and higher prices of energy items is likely to exert additional inflationary pressures elsewhere in the economy in coming months.

Inflation continues to be a most serious problem in the food sector also. In November, consumer food prices jumped at a 17 percent seasonally adjusted annual rate as declining prices for meat, poultry, and eggs were more than offset by rising costs of other foods and of restaurant meals. The November increase was the largest in three months and pushed food prices to a level 20 percent higher than a year ago.

EMPLOYMENT

According to the December household survey, the unemployment rate registered its second consecutive monthly increase of 0.2 percentage points. This brought the seasonally adjusted jobless rate to 4.9 percent, compared with the 3½-year low of 4.5 percent reached this past October. During December, as in November, employment edged down and the labor force grew by a small amount. Because the timing of the survey was such as to include only those individuals who were unemployed during the first week of the month, the December data were little affected by the repercussions of the oil embargo. Layoffs at automotive plants and among airline personnel, for example, have been concentrated in the weeks since the survey was taken.