The Business Situation

Economic activity appears to have begun a recovery following the sharp energy-shortage-induced decline that marked the first quarter.* Industrial production expanded moderately in April, after having decreased over the previous four months. New orders for durable manufactured goods and retail sales both advanced in April, boosted by a resurgence in the demand for automobiles. At the same time, backlogs of unfilled durables orders continued to mount and, despite the sluggish first quarter, large increases in expenditures on plant and equipment appear to be in prospect for the year. However, these statistics have to be interpreted with some caution, as they are expressed in nominal terms and thus in part reflect the rapid rate of inflation. The one sector of the economy for which the outlook remains troubling is residential construction. The recent sharp runup in interest rates and the loss of deposits at thrift institutions threaten to prolong and, perhaps, deepen the housing slump. The Federal Government's newly announced measures to bolster housing may succeed in stabilizing housing activity at about current levels.

Price developments remained disturbing in April. While food prices declined during the month, most other prices continued to spurt ahead. At an annual rate, the increase in consumer nonfood prices topped 10 percent again in April and was about equal to the rate of increase over the previous six months. In the same month, wholesale industrial prices climbed at almost a 28 percent annual rate, this too being about equal to the average rate of increase of the past six months. Moreover, the price increases that have occurred since the last of the price controls were removed were not reflected in the April data. In the next few months, these post-controls increases are likely to maintain the rate of inflation at very high levels.

* The revised first-quarter estimates indicate that gross national product (GNP) increased by $14.7 billion to a seasonally adjusted annual rate of $1,352.2 billion. The rate of increase in the implicit GNP deflator was revised upward to 11.5 percent per annum, and the rate of decline in real GNP was revised downward to −6.3 percent. According to the preliminary estimates released along with the GNP revisions, before-tax corporate profits increased $12.7 billion in the first quarter.

INDUSTRIAL PRODUCTION, ORDERS, AND INVENTORIES

In April, the Federal Reserve Board's index of industrial production rose at a 4.8 percent seasonally adjusted annual rate. In the four preceding months, total production had fallen at nearly an 8 percent annual rate, about 40 percent of which was directly attributable to the steep drop in automotive output. The April expansion in industrial output appeared to signal the end of the energy-shortage-induced declines of earlier months. Indeed, the production of motor vehicles and parts spurted at almost a 71 percent annual rate in April and accounted for almost two thirds of the rise in total output. Another healthy sign was the 9 percent growth in the production of iron and steel mill products. In contrast, during the December-to-March period, steel production had fallen sharply. Following the sizable decreases that had occurred since last October when the oil embargo began, total energy output remained virtually unchanged in April. Nevertheless, the gasoline situation has shown marked improvement. Whereas gasoline output had fallen over 45 percent at an annual rate from last October to January, it increased almost 30 percent from January to March.

Activity in the automotive sector of the economy picked up somewhat in April. Both production and sales increased for the first time in many months, rising to the highest levels since last December. New car assemblies rose 13.6 percent in April to a seasonally adjusted annual rate of 7.5 million units. This was, nevertheless, well below the 10 million assemblies averaged during the first six months of 1973. New domestic car sales rose 5.4 percent in April to a seasonally adjusted annual rate of 7.8 million units. A renewed interest in full-size models was primarily responsible for this stepped-up sales activity. Although greater availability of gasoline undoubtedly spurred purchases to some extent, dealer sales contests probably were also a contributing factor. Meanwhile, it also appears that the automobile inventories of retail dealers have finally been brought into line with sales. Inventories totaled 1.49 million units at the end of April, down from the November peak of 1.84 million. Moreover, dealers appear to have achieved a better balance in the mix of inventories between large and small automobiles.

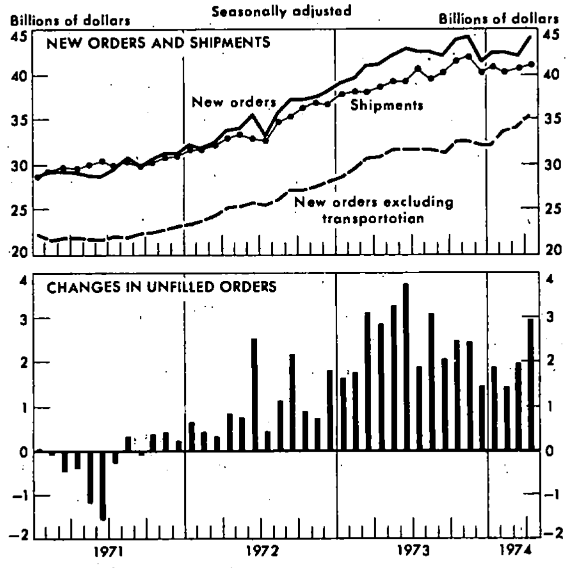
Seasonally adjusted new orders received by durable goods manufacturers posted a 4.9 percent, or $2.1 billion, gain in April (see Chart I). Large increases were recorded in orders for transportation equipment and for fabricated and primary metals, and these accounted for most of the overall advance. Despite the April rise, new orders for durable goods remained below the record levels attained late last year. However, in recent months, the behavior of this indicator has reflected the sharp reduction in the orders and shipments of automobile manufacturers. Excluding transportation equipment, new orders for durables have displayed a distinct upward trend throughout the year. As shipments were again below new orders in April, the backlog of unfilled durables orders mounted further.

The book value of manufacturers' inventories advanced in April at a $23.2 billion annual rate. This rate of accumulation was about the same as that of the previous month, and it was only slightly below the $25.6 billion increase averaged in the December-to-February period. According to disaggregated data, the buildup in inventories in recent months has not been evenly distributed among industries nor among inventories at different stages of fabrication. This unevenness is quite apparent, for example, in the inventory-to-sales ratios for manufacturing. For nondurable goods industries, the inventory-sales ratio in April remained at the near-record low levels of earlier months of the year. In contrast, the inventory-sales ratio for durable goods industries climbed further in April, rising to the highest level in over a year. However, the inventory accumulation by durables manufacturers does not appear to have been produced involuntarily by lagging sales, as the rise in inventories of durable finished goods has been relatively modest. Rather, most of the buildup has been in purchased materials and supplies and in goods in process, especially in the machinery industries. In view of the continued expansion in new bookings of these capital goods industries, this pattern of inventory accumulation is more symptomatic of economic strength than of weakness.

Chart I

ORDERS AND SHIPMENTS OF MANUFACTURED DURABLE GOODS

Seasonally adjusted



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

PERSONAL INCOME AND CONSUMER DEMAND

Seasonally adjusted personal income advanced at a $7 billion annual rate in April. Farm income fell, as agricultural prices continued to decline, but this was more than offset by the increased social security benefits which took effect during the month and by the gains in wage and salary disbursements. Indeed, about half the overall April advance stemmed from the rise in private wage and salary payments, with disbursements in the manufacturing sector increasing $1.3 billion following their sluggish behavior of the previous four months. This increase reflected not only the disproportionately large number of collective bargaining agreements reached during the month but also the renewed strength in manufacturing employment.

Retail sales turned in a strong performance in April, rising at a 16.9 percent seasonally adjusted annual rate. Most of the gain was attributable to increased automotive purchases, as sales of other goods edged up only slightly. However, over the three months ended in April, retail sales rose along a broad front; total retail sales climbed at a 13.8 percent annual rate over this period, and the increase was rather evenly distributed among automotive, other durable, and nondurable goods. For the year ended April 1974, the growth in current-dollar retail sales amounted to 7.8 percent, down from the 13.5 percent increase posted during the previous twelve-month period. In view of the concomitant acceleration in consumer prices, the slowdown in retail spending was considerably greater in real terms.

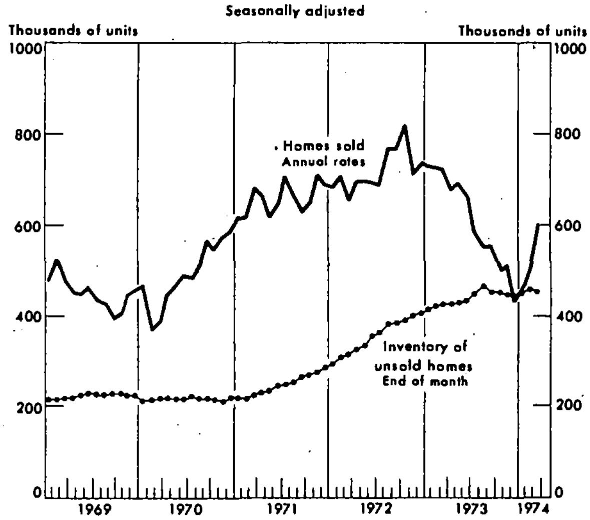
The spurt in consumer prices, moreover, appears to have given rise to a shift in the composition of consumer spending. Evidently as a result of the sharply rising prices of food and energy, consumers have been devoting an increasingly smaller share of their budgets to purchases of durable goods, which tend to be postponable. In the event that the pace of inflation slows and other uncertainties in the economic situation fade, consumers may well return to their former spending patterns.

RESIDENTIAL CONSTRUCTION

The prospects for a full-fledged recovery in residential construction from its recent slump have begun to dim, despite some signs of temporary improvement. Private housing starts rose in April to a seasonally adjusted annual rate of 1.63 million units, up from the previous month but about equal to the average of the first three months of the year. Merchant builders' sales of new one-family homes rose steadily over the first quarter to a seasonally adjusted annual rate of 600,000 units in March, the latest month for which data are available (see Chart II). This sales rate was almost 40 percent above the depressed December level and was the highest since last June. However, the inventory of unsold homes remained near the record level attained last August. Moreover, the leveling-off in these inventories over the past six months conceals a shift in their composition that does not augur well for home building. Since August, the percentage of homes completed but not sold has increased from 22 percent to 29 percent of total inventories while the proportion of unsold homes not yet started—that is, where a permit has been issued but ground not broken—has fallen to the lowest level in about three years. Hence, there is a relatively large volume of completed but as yet unsold homes on the market. This may account for the lethargic behavior of newly issued building permits in recent months.

In the near term, the recent runup in market interest rates is likely to have a severely constricting effect on mortgage availability. Indeed, the higher interest rates appear to have given rise to a large outflow of deposits at New York State savings banks in April. In that month, too, deposits at savings and loan associations rose at a 4.9 percent seasonally adjusted annual rate, well below the 10.2 percent rise posted in the first quarter of the year. Some tightening in the mortgage market is already in evidence. For example, between mid-March and early May, the average yield on four-month commitments on

Chart II
NEW ONE-FAMILY HOMES
Seasonally adjusted



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

Government-insured mortgages at auctions conducted by the Federal National Mortgage Association jumped more than 1 percentage point to 9.48 percent, establishing a new record.

With the slowing in thrift institution deposit flows, the Federal Home Loan Bank (FHLB) Board, in an attempt to encourage mortgage lending, has rescinded its previously announced increase in the proportion of liquid assets that savings and loan associations must maintain. In addition, the FHLB Board may soon act to allow savings and loan associations to issue negotiable large-denomination certificates of deposit (CDs). At present, savings and loan associations can issue only nonnegotiable CDs, which carry stiff penalties for early withdrawals. While this proposal, if implemented, will enable savings and loan associations to compete for funds, the impact on housing is far from certain, since usury ceilings in many states still may restrict mortgage lending. In those states without ceilings or with very high ceilings, potential home buyers may well balk at the high mortgage interest rates.

In addition to these FHLB Board actions, the Administration announced in early May that it would soon institute a new housing program. The program consists of an expansion of the "Tandem Plan" subsidies on Federal Housing Administration-Veterans Administration mortgages, further advances by the FHLBs to savings and loan associations at bargain rates, and a new FHLB program allowing the Federal Home Loan Mortgage Corporation to purchase conventional mortgages at below-market rates. Together, these three actions could pump as much as $10.3 billion into the mortgage market. The extent to which this program will benefit the residential construction sector is in question, however. Thrift institutions will undoubtedly use only a portion of the $10.3 billion to extend new mortgages. The rest will be used in one way or another to offset current and near-term deposit withdrawals. Moreover, whatever proportion of the $10.3 billion is used to acquire new mortgages, some of these mortgages will doubtless cover new homes that are already built but not yet sold. While this would reduce the overhang of unsold new homes, builders may nevertheless be reluctant to begin constructing additional new units.

PRICES

Consumer prices, seasonally adjusted, rose in April at a 6.9 percent annual rate, the first time in four months that the rate of increase was below the 10 percent mark. However, the slowdown was almost entirely attributable to a 5.3 percent rate of decrease in consumer food prices, the largest drop in seven years. Prices of nonfood commodities, on the other hand, advanced in April at a 12.8 percent annual rate, a bit above the average increase of the previous six months. Evidently, the huge rise in wholesale industrial prices in recent months is being translated into increases at the consumer level. Once again, skyrocketing energy prices led the overall April rise, as prices of consumer power and fuel spurted ahead at a 24 percent annual rate.

At the wholesale level, prices of farm products and processed foods and feeds declined sharply in April for the second consecutive month. These prices dropped at an annual rate of nearly 36 percent in April. However, during the last year or so, monthly movements in wholesale farm prices have been quite erratic, registering extraordinarily large increases and decreases within the space of a few months. Furthermore, the April drop is attributable mainly to declining grain and livestock prices, and there are some indications that the fall in livestock prices may soon be reversed. Beef prices have declined in response to forces set in motion about six months ago, when large numbers of cattle were placed on feed. In recent months, the number of cattle placed on feed lots has fallen off dramatically.

In April, wholesale industrial prices shot ahead at a 27.8 percent seasonally adjusted annual rate. The advance in wholesale power and fuel prices slowed noticeably, but the increase in other wholesale industrial prices amounted to a disturbing 31.5 percent on an annual rate basis. By comparison, over the preceding three-month period these prices had risen at a 20.6 percent rate. The single most important factor behind the recent surge in wholesale industrial prices has been the soaring price of metals, particularly steel. This surge in wholesale industrial commodity prices is especially disconcerting, since additional price rises were announced as the final vestiges of wage and price controls were removed. These increases have not yet appeared in the major price indexes.