The Business Situation

Economic activity continues to contract. While pervasive weakness in final demand has been a contributing factor, the dominant depressant in recent months has been the liquidation of inventories. Indeed, at the present time, the inventory correction appears to be the most important single factor restraining production and employment. In February, industrial production fell 3 percent, marking the fifth consecutive monthly decline. No doubt this protracted contraction in output has occurred in response to the sizable cutbacks in business capital spending and to the unusually steep decline in orders for other manufactured goods. Conditions in the labor market have lately evidenced a pronounced weakening, with the unemployment rate rising from 8.2 percent in February to 8.7 percent in March.

Despite the decidedly downward thrust of the economy, a few encouraging signs have appeared. Retail sales have staged an advance in recent months, even after allowing for concurrent price increases, and many retailers report improving inventory positions. Automobiles sales, boosted by the fall in effective prices, were comparatively brisk in February and have led to a noticeable reduction in the overhang of automotive inventories. The enlarged flow of funds into thrift institutions should eventually give rise to a recovery in residential housing construction, once the surplus of unsold new homes has been reduced a bit. These encouraging signs are quite tentative, however. While an economic upturn is in prospect, its timing and magnitude are still in question.

In coming months, further impetus to an economic recovery will derive from the tax-cut bill that was enacted by the Congress and signed into law by President Ford at the end of March. On balance, the new bill will amount to an estimated $22.8 billion reduction in personal and business taxes in 1975 and 1976. Included in the new legislation are several provisions that will benefit individuals. First, one provision calls for a 10 percent rebate on personal income taxes for 1974, totaling about $8.1 billion. While all taxpayers will benefit to some extent, those with adjusted gross incomes of $20,000 or less will receive greater tax relief. Second, in 1975, personal income tax liabilities will be reduced by about $7.8 billion. This reduction will be effected through a $30 tax credit for every taxpayer and his dependents and through increases in the standard deduction. Third, a tax credit for low-income families with children will reduce personal tax liabilities by about $1.5 billion in 1975. Fourth, at an estimated cost of $1.7 billion, all social security recipients, railroad retirement pensioners, and aged, blind, and disabled welfare recipients are scheduled to receive a $50 cash payment sometime in the summer. Fifth, unemployed workers will be able to draw unemployment compensation for an additional thirteen weeks, extending the period of eligibility to sixty-five weeks. Sixth, a 5 percent tax credit of up to $2,000 will apply toward the purchases of new houses that had been built or were under construction by March 25 and that are to be principal residences. Designed to stimulate residential construction, this measure will decrease personal income taxes in 1975 by about $0.6 billion.

Taken together, the other provisions in the new legislation will lower business taxes by about $3.1 billion. First, the investment tax credit for purchases of equipment is to be increased to 10 percent for two years, up from the 7 percent credit that had been in effect for most businesses and the 4 percent credit for utilities. Also, the amount of used equipment eligible for the credit was raised from $50,000 to $100,000, a change that will primarily benefit smaller businesses. These and other related provisions will reduce business tax liabilities by an estimated $3.4 billion. Second, the reduction in the tax rate applied to the first $50,000 of their profits will result in a $1.4 billion decrease in corporate tax liabilities. Partly offsetting these tax breaks, however, are two other measures that will increase the tax liabilities of some businesses. The oil depletion allowance was eliminated for the large oil companies and will be gradually phased out for many smaller firms. And major changes were made in the tax treatment of multinational corporations. In the aggregate, the personal and corporate tax reductions provide a needed element of prompt economic stimulus. However, their implications for the long-term health of the economy are problematic. The tax bill substantially reduces the number of tax-paying citizens and decreases the Government's revenues from important sources. While these changes are presently considered temporary, they would constitute a marked erosion of the tax base with inflationary overtones should they become permanent fiscal arrangements.

On the price front, the outlook continues to be encouraging. Recent developments suggest that the combination of plummeting materials prices and slackening demand has begun to exert a dampening effect on finished goods prices. Consumer prices rose during February at a 7.7 percent annual rate, mainly because of a considerable softening in retail food prices. And wholesale prices in March declined for the fourth consecutive month. The prices of farm products and related items accounted for much of the weakness, although prices of industrial commodities increased at only a 2.2 percent annual rate.

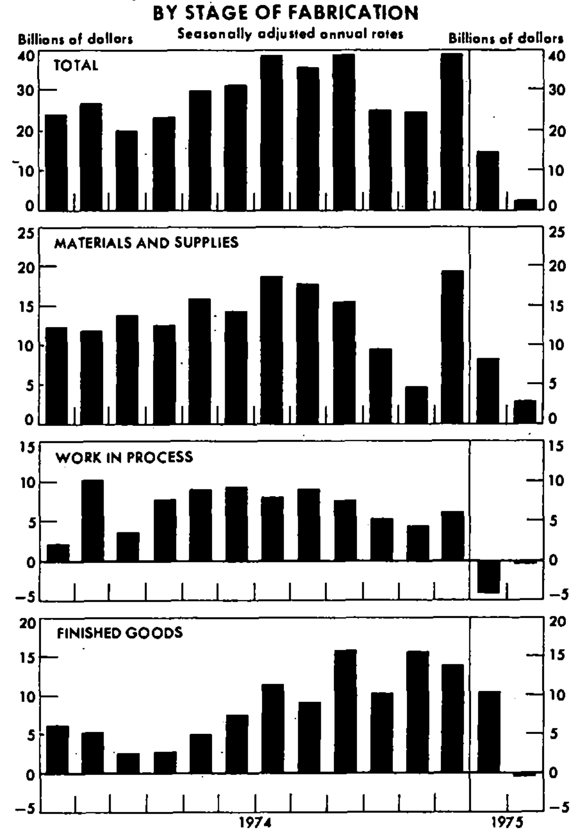
INDUSTRIAL PRODUCTION, ORDERS, AND INVENTORIES

Industrial production fell 3 percent during February. This decline, the fifth in a row, brought the Federal Reserve's index of industrial production to 110.3, 12 percent below its September 1974 level. As in previous months, the February decline in manufacturing output was more noticeable in durable goods. Since September, the production of durable goods has fallen 15 percent, while nondurables are off about 11 percent. The production of automobiles and parts fell again in February but at a somewhat slower rate than in recent months. The February decline was 4.7 percent, compared with an average monthly reduction of 11.5 percent since October. The output of business equipment was reduced again in February and has fallen 9.8 percent since September. In addition to the cutbacks in durable goods production, the output of industrial materials was noticeably reduced both in February and during the preceding few months. The production of industrial materials fell 3.8 percent during February, bringing the total decline during the past five months to 17.9 percent.

New orders for durable goods increased by $900 million during February. This rise reversed a five-month trend during which durable goods orders declined by $13 billion, or 27 percent. A good portion of the February increase is attributable to a $479 million growth in the often volatile orders for defense equipment. However, orders for primary metals and household durables also showed significant advances. The 6.9 percent rise in orders for primary metals suggests that inventories of these metals are finally running down, which could stimulate an upturn in their production. The increase in orders for household durables was also the first in several months and, although it is but one indicator, it could reflect improvement in consumer confidence, which has deteriorated steadily over the past year. Another favorable sign in durable goods is that orders for nondefense capital goods were little changed in February. These orders had declined on balance over the previous five months, falling by 14.9 percent during the September-January period.

The book value of total business inventories declined in

Chart I
CHANGES IN MANUFACTURERS' INVENTORIES BY STAGE OF FABRICATION



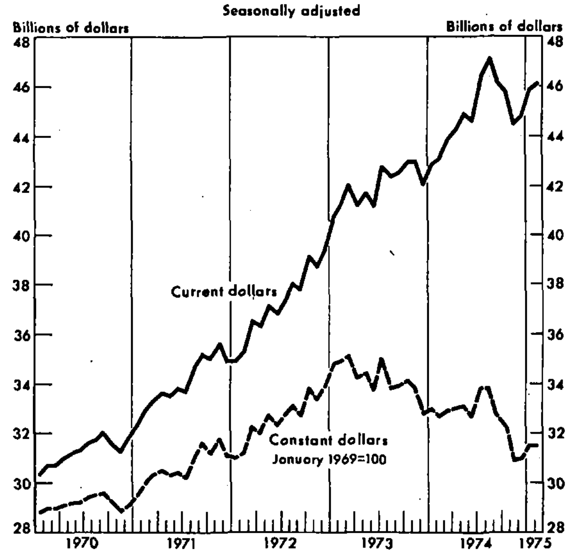
Source: United States Department of Commerce, Bureau of the Census.

January for the first time in over four years. The January decrease was $148 million, compared with a seasonally adjusted $3.9 billion increase in December and a $45 billion gain over the previous twelve months. The January decline in all business inventories was caused by substantial reductions in the wholesale and retail trade sectors. Apparently, the pattern in recent months of declining orders to manufacturers against relatively stable wholesale and retail sales has resulted in a running-down of inventories at the wholesale and retail levels. Should this pattern continue, one would expect a restoration of orders to manufacturers in the near future and eventually a higher rate of industrial production.

Approximately one half of the January decline in retail inventories is attributable to automobiles. Automobile dealers' inventories fell even further in February, and at the month end their inventories amounted to sixty days of sales. This is the lowest inventory-sales ratio since September and is substantially below the November level, when dealers held inventories equal to 101 days of sales. Of course, the February figure was lowered by the price rebate program which stimulated sales.

Manufacturers' inventories increased in February but by only 0.1 percent, their smallest gain in three and one-half years. Stocks of finished goods actually declined by $30 million, and work in progress fell by $30 million as well (see Chart I). The entire inventory increase was in materials and supplies, which rose by $245 million. Presumably, the failure of materials stores to decline is partly explained by the fact that some manufacturers are taking advantage of increasingly attractive materials prices.

Chart II
RETAIL SALES
Seasonally adjusted



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

PERSONAL INCOME, CONSUMER DEMAND, AND RESIDENTIAL CONSTRUCTION

Personal income increased in February by a seasonally adjusted $2.9 billion to an annual rate of $1,194 billion. The February increase was somewhat larger than the gain recorded in January; however, it was quite small compared with the average monthly gain for 1974. Reflecting recent declines in production, payrolls in manufacturing and other commodity-producing sectors dropped at a seasonally adjusted annual rate of $5.7 billion. Income in the service and distribution industries increased at a $2.5 billion rate, however, and limited the decline in total private payrolls to $3.2 billion. Unemployment benefits, which have climbed quickly with the unemployment rate in recent months, increased by $2.7 billion in February. This jump, along with a rise in social security, unemployment, and veterans' benefits, brought the increase of total transfer payments to an annual rate of $6.7 billion. Farm income moved lower in February for the fifth consecutive month, falling 12 percent to a $23 billion annual rate. Over the twelve-month period ended in February, farm income has fallen by 41 percent.

Consumer spending at retail stores registered a marginal increase of $210 million during February. This was the third consecutive month in which retail sales have risen (see Chart II). However, the gains have been quite small, and sales have yet to regain their level of last September. Of the February increase, approximately two thirds was in the durable goods category and was accounted for by automobile sales. During that month, passenger car sales, reflecting the effects of the price rebates offered by most manufacturers, proceeded at an annual rate of 7.2 million units, compared with an average of 6.2 million units during the previous four months. In March, after many of the special sales programs ended, automobile sales declined sharply to a 6 million unit annual rate, the slowest sales pace since November.

The housing picture is still decidedly weak. Housing starts fell by 2 percent in February to an annual rate of 977,000 units from January's 996,000. This pace of starts was somewhat higher than December's low of 880,000 starts, but it was 48 percent below the level of last February. Permits to build new housing units were down in February to a record-low annual rate of 673,000 units. Permits to construct multifamily dwellings fell to 106,000, 80 percent below the level of last February. Meanwhile, permits for single-family residences increased for the second consecutive month to an annual rate of 514,000.

Sales of new single-family houses increased by 2 percent in January to 395,000, compared with December's 387,000 sales. By the end of January, the combination of low housing starts and somewhat faster housing sales had reduced the inventory of unsold single-family houses to approximately 400,000 units, nearly 50,000 houses fewer than the inventory of a year ago but, because of the recent slow pace of sales, the ratio of inventory to sales in January was somewhat higher than it had been a year earlier.

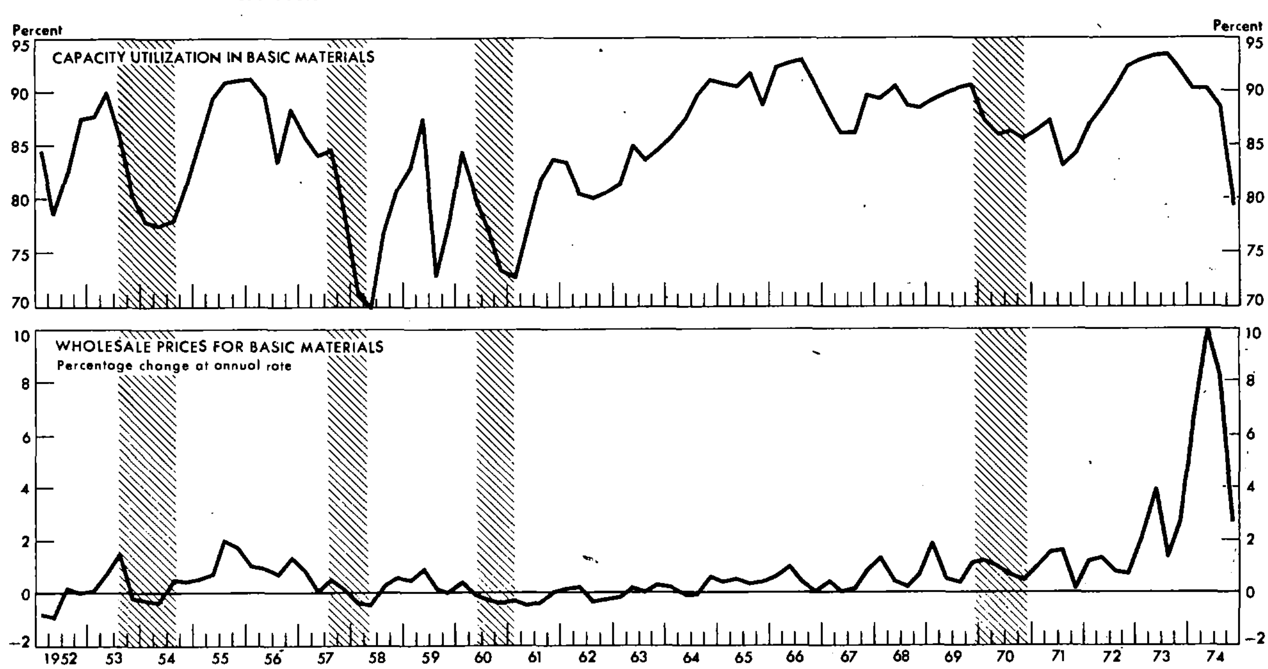
SUPPLY OF BASIC MATERIALS

Against the backdrop of a weakened economy and excessive inventory accumulation, substantial amounts of excess capacity have developed. The existence of unused capacity has been influential during business cycles in the past, and it will doubtless condition the real output and price performance of the economy in the near future. Nowhere has unused capacity been more evident than in the basic materials industries where utilization rates fell from an average 93 percent in 1973 to 79.3 percent in the fourth quarter of 1974, the lowest level in more than thirteen years. With the exception of the paper industry, which has continued to operate at nearly full capacity, this decline has been broadly based as well. To cite a few examples, utilization in the chemicals industry dropped from 90 percent in the fourth quarter of 1973 to 72 percent one year later, and metal producers were operating at 84.5 percent of capacity in the October-December 1974 period, down 8.7 percentage points from the peak reached in the final three months of 1973.

Judging from previous years, however, the capacity constraints and materials shortages which characterized 1973 were unusually severe. Materials producers' capacity utilization rates rose above 90 percent during each of the four

Chart III

CAPACITY UTILIZATION AND WHOLESALE PRICES OF BASIC MATERIALS INDUSTRIES



Note: Shaded areas represent recession periods, indicated by the National Bureau of Economic Research chronology.
Sources: United States Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System.

post-World War II economic booms, and forward commitments of purchasing agents lengthened considerably. But, while a maximum of only 50 percent of purchasing agents believed it necessary to order materials more than ninety days in advance during each of the three earlier booms, 65 percent believed such a lead time necessary in 1973. In retrospect, the unusually tight bottlenecks that occurred at the end of 1973 are probably attributable to the effects of the Economic Stabilization Program and the devaluation of the United States dollar.

In any event, supply constraints similar to those that developed in 1973 are not likely to reappear in the near future. As indicated in Chart III, while changes in the utilization rate for materials producers tend to mirror swings in overall economic activity, slack has often persisted beyond the onset of recoveries. Moreover, since materials prices are extremely sensitive to prevailing supply conditions, inflationary pressures have eased for several quarters beyond the business-cycle troughs as well. After falling rather sharply during the contractions in 1953-54 and 1957-58, for example, capacity utilization picked up, but it did not return to its earlier cyclical peak until four quarters after the economy started to rebound. Although materials prices immediately began rising in response to the improvement in economic activity in the third quarter of 1954 and in the second quarter of 1958, these increases were smaller than they had been during each of the previous expansions. In 1961 the decline in utilization was not nearly so dramatic, since a large amount of surplus capacity already existed and only two quarters passed before the earlier peak was attained. Despite this, materials prices remained quite stable, failing to rise significantly until the end of 1964. More recently, the mild decline in utilization which occurred in 1970 required two full years before capacity utilization approached the peak established in the fourth quarter of 1969 and materials prices began to accelerate.

Cyclical declines in plant utilization have tended to stretch beyond general economic contractions partly because of the bursts in capital investment that typically have occurred during the prior expansion. As measured by the Commerce Department, over the year preceding each of the four postwar cyclical peaks, capital spending by major materials producers rose an average $1.1 billion above year-earlier levels. However, since fairly long periods must expire before new plant and equipment emerge from these expenditures, additions to capacity have rarely surfaced until recoveries were under way. In this respect, a very similar pattern seems to be unfolding for 1975. Capital spending in 1973 rose $3.1 billion above the 1972 level and, while a portion of the increase was caused by inflation, even in real terms there was a substantial jump. As a result, a sufficient amount of new capacity should emerge during 1975 so that the current slack in utilization may persist for a time, thus helping to temper a rekindling of inflationary pressures.

PRICE DEVELOPMENTS

Consumer prices increased at a seasonally adjusted annual rate of 7.7 percent during February. This was the second consecutive month in which the consumer price index rose at this rate, providing additional evidence that inflation has fallen back from the rates in excess of 10 percent that were experienced during 1974. The February increase brought the annual rate of consumer price rise for the three-month period since November to 7.8 percent, compared with 12.4 percent for the previous three-month interval. During the twelve months ended in February, consumer prices advanced 11.1 percent.

Retail food prices increased at only a 0.7 percent annual rate during February, their slowest rise since last July. This break in the rate of food inflation reflects, among other factors, a working-forward of the lower wholesale food prices that have been observed during recent months. For example, for the three-month period ended in February, wholesale prices of farm products and processed foods and feeds fell at nearly a 33 percent annual rate.

Excluding foods, the consumer price index advanced at a 10.3 percent annual rate in February, compared with 7.9 percent in January. The prices of nonfood commodities increased at a 10 percent rate, while service prices rose at a 9.7 percent pace. Among the commodity group, price rises were most pronounced among durable goods, which rose at a 12 percent annual rate. Looking at energy prices, consumer fees for gas and electricity increased at a 17.3 percent annual rate, while the prices of fuel oil and coal declined at a 0.5 percent pace.

Wholesale prices fell at a seasonally adjusted annual rate of 7.4 percent in March, sustaining a decline that set in last December. As in previous months, the reduction was due entirely to lower agricultural prices. Wholesale farm and feed prices dropped at a 30.4 percent annual rate in March, bringing the decline over the last three months to 33.1 percent. Moreover, with spot prices of foodstuffs moving down in recent weeks, the prospect of additional declines at the wholesale level appear likely. At the same time, wholesale prices of industrial commodities slowed to a 2.2 percent annual-rate gain in March. Over the past six months, industrial commodities prices have increased at a 6.5 percent annual rate, well below the 31.5 percent advance posted over the first half of 1974.

LABOR MARKET DEVELOPMENTS

Unemployment in March rose to 8.7 percent of the civilian labor force, after having held steady at 8.2 percent the preceding month. The number of unemployed persons increased by almost 500,000 to nearly 8 million, the largest number of workers without jobs since 1940. The latest rise in unemployment was caused both by a sizable number of entrants into the labor force and by a reduction in employment. During March, the civilian labor force expanded by 320,000 persons to 91.8 million, while the number of persons employed dropped by 180,000 to 83.9 million workers. All of the major categories of workers experienced higher unemployment in March; however, reflecting the continuing fall in industrial production, blue collar workers were especially hard hit. The unemployment rate among blue collar workers rose to 12.5 percent, compared with 10.9 percent in February.

Average hourly earnings increased in March at their fastest rate in nine months. The March gain was at a 12.9 percent annual rate, compared with increases of 6.5 percent in January and February. Earnings moved higher in all major industries. The gains were especially large in construction, where earnings rose at more than a 30 percent annual rate, after having declined at about a 13 percent rate during February. Reflecting the low level of construction activity over the past year, earnings in construction have risen more slowly than in other industries. For example, since March 1974, average hourly earnings in construction increased 8.5 percent, compared with an 11.4 percent rise in manufacturing and a 13.7 percent advance in mining wages.