The Business Situation

The latest readings on economic activity indicate continued substantial expansion in the domestic economy.[1] Consumer spending has remained in the forefront, as retail sales posted a strong advance in January. Seasonally adjusted purchases of new domestic-type automobiles continued strong in February. Housing starts climbed further in January after a very vigorous fourth quarter, and new orders for durable manufactured goods surged ahead. While overall industrial production rose moderately, output of business equipment increased sharply, surpassing the previous peak set in the fall of 1969. There is evidence of a more vigorous buildup of inventories and greater strength in the capital goods area.

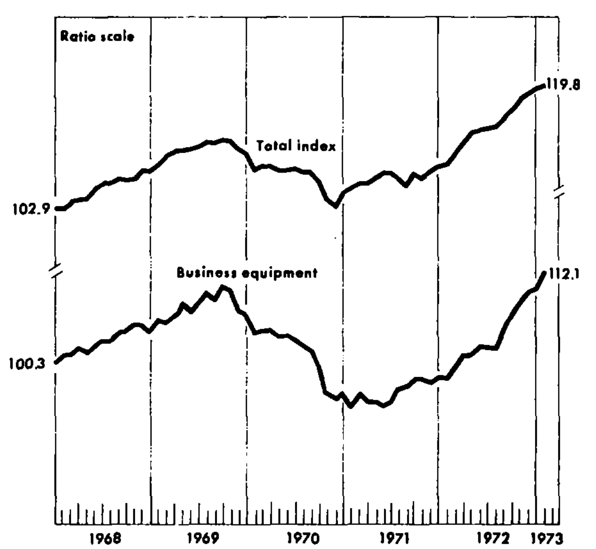
The near-term outlook for prices, on the other hand, appears discouraging. Wholesale prices of agricultural products advanced at a very rapid rate in February, following a similar increase in January and marking the fourth consecutive month of inordinately large advances. These increases have begun to be reflected in consumer food prices; in January, such prices soared at a seasonally adjusted annual rate of 25 percent. Although consumer nonfood commodity prices were steady in January, wholesale industrial commodity prices shot up in February at the fastest rate in over twenty years. This increase seems likely to be reflected in higher prices at the consumer level in the months to come.

INDUSTRIAL PRODUCTION, ORDERS, AND INVENTORIES

The growth of industrial output apparently moderated somewhat in January after rising very strongly during 1972. The Federal Reserve Board's index of industrial production rose at a 6 percent seasonally adjusted annual rate in January by comparison with the 10.2 percent advance experienced over the preceding year. Output of business equipment climbed sharply in January to a level surpassing the previous peak of September 1969 (see Chart I), and output of consumer nondurable goods moved up as well. On the other hand, production of materials and intermediate products was virtually unchanged, while output of consumer durables and defense and space equipment declined. Domestic car production, at seasonally adjusted annual rates of 9.7 million units in January and 10.1 million in February, while below the unusually high December rate, was well above the 8.8 million units produced in all of 1972.

Preliminary data indicate that new orders for durable

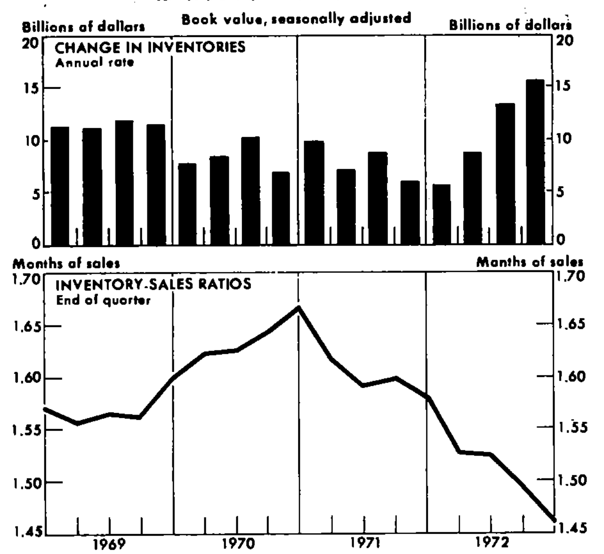
Chart I
INDUSTRIAL PRODUCTION
Seasonally adjusted; 1967=100



Source: Board of Governors of the Federal Reserve System.

[1] In its revised figures for fourth-quarter 1972 gross national product (GNP), the Department of Commerce reduced its estimate of current-dollar GNP from $1,195.8 billion to $1,194.9 billion. This downward revision stemmed primarily from smaller increases in consumption and government spending. Growth in real GNP in the fourth quarter was not so rapid as first estimated, although it was still a strong 8 percent. On the other hand, the estimate of the implicit price deflator for GNP was raised marginally.

Chart II
INVENTORY ACCUMULATION AND INVENTORY-SALES RATIOS FOR TOTAL BUSINESS



Note: Changes are from end of quarter to end of quarter.
Source: United States Department of Commerce, Bureau of the Census.

manufactured goods rose in January by a huge $2.2 billion, or nearly 6 percent. Defense bookings increased considerably after declining in December. In addition, new orders for nondefense capital goods expanded by almost $0.5 billion, substantially more than the average increase over the previous six months. Bookings for primary metals and machinery also moved up in January. Shipments increased markedly as well but remained below the level of new orders. As a result, the backlog of unfilled orders climbed significantly for the sixteenth consecutive month.

Business inventory spending has continued at an accelerated pace in recent months. In December, the book value of manufacturing and trade inventories increased $16.1 billion at a seasonally adjusted annual rate, bringing the average monthly gain for the fourth quarter to $15.6 billion. This gain surpassed the third-quarter average of $13.3 billion and was well above the rate of inventory accumulation in the first two quarters of the year (see Chart II). During the fourth quarter, sales advanced more rapidly than inventories so that the ratio of inventories to sales declined to 1.46, down from 1.49 three months earlier. At the end of 1971 the inventory-sales ratio had stood at 1.58.

Over 1972 as a whole, business inventories climbed by $10.8 billion, almost $3 billion more than the 1971 increase and the largest yearly gain since 1969. Over half of the increase in stocks occurred in manufacturing inventories. In turn, much of this buildup was in durable goods industries and stemmed in part from the vigor of motor vehicle production during the year as well as from the rebound in the aircraft industry. Preliminary data for January indicate that manufacturing stocks edged up further at a $2.6 billion seasonally adjusted annual rate. The increase in durables manufacturers' inventories more than offset a slight decline in nondurables inventories.

RESIDENTIAL CONSTRUCTION, RETAIL SALES, AND PERSONAL INCOME

Residential construction activity is continuing at a very rapid rate. In January, private housing starts surged to a seasonally adjusted annual rate of 2.5 million units. Although the multifamily total fell somewhat from the unusually high December level, it was only slightly below the average for 1972. Single-family housing starts, on the other hand, rose to a new high in January, exceeding the previous record set in January 1972. It should be noted, however, that starts may have been artificially boosted in recent months as some builders may have accelerated activity prior to the freeze on Federal subsidy programs. Newly issued building permits fell 8.1 percent in January from the very high level of the previous month.

Sales of new one-family homes in December, the most recent month for which data are available, rose to a seasonally adjusted rate of 724,000 units. Builders' inventories of unsold new homes were at 404,000 at the end of December, leaving the ratio of unsold new homes to sales of new one-family homes only slightly below the very high November level. The vacancy rate on residential rental properties fell to 5.6 percent of available stocks in the fourth quarter, down from the third-quarter average of 5.8 percent. The average rate for the four quarters of 1972, however, was the highest annual rate since 1968. Vacancy rates on homeowner properties rose slightly in the fourth quarter of 1972, but were unchanged from the level of a year earlier.

Consumption spending was also strong in January, as seasonally adjusted retail sales rose $1.2 billion above the upward revised December level. The increase was broadly based in sales of both durable and nondurable goods. The continuing strength of the auto market was evident in January sales of new domestic-type automobiles, which reached a seasonally adjusted annual rate of 10.3 million units on the heels of fourth-quarter sales that averaged 9.9 million units at an annual rate. Moreover, the January sales pace was the most rapid rate since September 1971, when domestic car sales were stimulated by the price freeze, the removal of the excise tax on automobiles, and the import surcharge. Auto sales continued high in February at a seasonally adjusted annual rate of 9.9 million units, including a record 2 million of imported cars. Demand for imported cars was undoubtedly stimulated by expectations of price increases for imports in the future stemming from the devaluation of the dollar.

Further sizable advances in retail sales appear possible in the months ahead. Substantial tax refunds are expected in the first half of the year as a result of the overwithholding of personal income taxes in 1972. Undoubtedly, some of these funds will be channeled into consumption. Furthermore, the latest surveys of consumer intentions indicate continued strength in expenditures. At the same time, however, the University of Michigan Survey Research Center reported a leveling-off of consumer optimism in the fourth quarter of 1972, albeit at a relatively high level. There is some evidence in the Michigan survey that consumers have become more concerned in recent months about rising prices of essentials.

Personal income rose only $2.5 billion in January to a seasonally adjusted annual rate of $985.4 billion. This was a small gain, compared with monthly increases in the fourth quarter of 1972 which averaged $12 billion. A number of factors, however, acted to inflate the fourth-quarter increases in personal income, particularly a 20 percent rise in social security benefits in October. On the other hand, personal income in January was reduced $5.2 billion by an increase in social security contributions, although this was offset to some extent by a Federal civilian and military pay raise. In the absence of these special factors, the January increase would have been $5.8 billion, slightly lower than the revised December increase of $6.7 billion.

PRICE DEVELOPMENTS

The persistence of inflationary pressures is evident in the latest price statistics. Wholesale prices advanced at a very rapid 21 percent seasonally adjusted annual rate in February following increases of 13.5 percent in January and more than 21 percent in December. The primary source of the December and January increases was the surge in prices of farm products and processed foods and feeds, which climbed at a seasonally adjusted annual rate of about 60 percent over those two months. Such prices continued to rise sharply at a 46 percent seasonally adjusted rate in February. Moreover, wholesale prices of industrial commodities in February soared at a 12 percent seasonally adjusted annual rate, the highest monthly increase in over twenty years. The February increase compared with a 4 percent rate of rise in January and was much higher than the 2.6 percent rate of increase experienced over the second half of 1972. The February surge in wholesale industrial commodity prices was broadly based in the various industrial subsectors but with particularly large gains in prices of fuel and related products and in lumber prices. On March 6 the Cost of Living Council announced the imposition of mandatory price controls on oil companies with annual sales of above $250 million.

Consumer prices rose at a rapid seasonally adjusted annual rate of 6.5 percent in January, up markedly from the December rise of 2.6 percent. Over the past three months, consumer prices have risen at about a 4 percent pace. Food prices soared at an annual rate of more than 25 percent in January and largely accounted for the increase in the overall index. In light of the continuing rapid run-up in prices of agricultural products at the wholesale level, the outlook for consumer food prices does not appear encouraging. Prices of nonfood commodities were unchanged in January, and over the past year such prices have climbed only about 2.4 percent. The advance of services prices moderated to a 2.7 percent annual rate of increase in January, compared with a 4.5 percent rise in the previous month.