The Business Situation

Economic activity apparently declined early in 1974. Much of this weakness can be attributed to the effects of the Arab oil embargo which, while weighing very heavily on particular sectors, has had widespread ramifications. Industrial production fell in January for the second consecutive month, with reductions in energy and auto output accounting for about half of the total January contraction and all of the December decline. Sales of new domestic-type passenger cars slumped somewhat further in February to the slowest pace in three and one-half years. Personal income also dropped significantly in January, partly as a result of reduced employment in several key sectors and a widespread shortening of the workweek. A substantial portion of the rise in unemployment during recent months can be traced to the direct and indirect consequences of the energy shortage.

There are, however, some tentatively encouraging signs. Residential construction activity perked up somewhat in January, as housing starts rose from the 3½-year low of the month before and newly issued building permits also increased. In addition, retail sales registered a sizable increase in January. New orders for durable goods rose nearly 5 percent in January, after dropping more than 6 percent during the previous month, and the backlog of unfilled orders continued to climb. Recent evidence suggests that business capital spending plans for 1974 may have strengthened in the face of the energy shortage. A special survey conducted by McGraw-Hill projects a large 18 percent increase in capital outlays. Inventory accumulation has been rapid and, while extraordinary price increases have greatly inflated book values, a substantial amount of real inventory accumulation has been taking place. The accelerated pace of physical accumulation apparently represents investment that is intended by business, with the exception of the automotive sector where a substantial buildup of unsold large cars occurred late last year. Even here, though, inventories seemed to be moving toward a somewhat more balanced condition in February since new domestic auto sales once again outpaced assemblies.

Meanwhile, inflation has intensified. Based on revised data, the gross national product (GNP) deflator climbed at an 8.8 percent annual rate in the fourth quarter of 1973, up from the original estimate of 7.9 percent.[1] Led by soaring food and energy costs, prices at both the wholesale and retail levels advanced along a broad front in January.

INDUSTRIAL PRODUCTION, ORDERS, AND INVENTORIES

The Federal Reserve Board's index of industrial production declined at a 9½ percent seasonally adjusted annual rate in January after falling at a 7½ percent pace in the previous month. By way of perspective, industrial output had climbed rapidly into early 1973, rising more than 12 percent over the year ended February 1973 (see Chart I). As the year wore on, a noticeable slowing in production growth emerged; output rose at a 4.4 percent annual rate during the February-November interval, when a wide variety of capacity limitations and shortages held the rate of increase in check. The declines of December and January bear the unmistakable imprint of the Arab oil embargo. Cutbacks in automotive production and energy output accounted for all of the reduction in December and half of the January dip.

Passenger car assemblies fell 16 percent in January to a seasonally adjusted annual rate of 6.9 million units, the slowest pace since late 1970 when auto output was depressed by the strike at General Motors. Current produc-

[1] The estimate of fourth-quarter current-dollar GNP growth has been revised upward from $29.5 billion to $33 billion. Investment in business inventories was raised from a $15.9 billion to an $18 billion rate. Net exports were also raised significantly. On the other hand, consumption spending turned out to be even weaker than first indicated, with outlays up by only $9.2 billion. In real terms, GNP is now estimated to have grown at a 1.6 percent annual rate in the fourth quarter, compared with the initial estimate of 1.3 percent.

tion is symptomatic of the continuing low overall level of auto sales and the exceptionally high stocks of unsold large cars held by retail dealers. Moreover, production has been somewhat constrained because the industry is currently undergoing a major retooling process in an effort to increase production of the very popular smaller cars. Preliminary data suggest that passenger car output decreased modestly further in February.

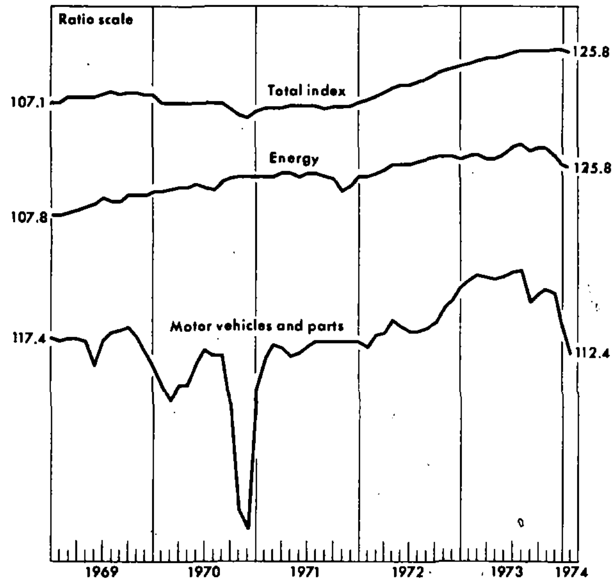
The energy component of industrial production, which includes refined petroleum products, electric power, and gas utilities, dropped at a seasonally adjusted annual rate of 9½ percent in January after falling at a 42 percent annual rate in December. In January, energy production was off nearly 3 percent from its year-earlier level. It is interesting to note that the nation's output of energy peaked last July and began to decline somewhat before the start of the Arab oil embargo. The most recent drop continues to reflect a shortage of petroleum which is related to the embargo, as well as conservation measures taken by residential and industrial users, and the abnormally mild weather which covered much of the nation during the last half of January. On the other hand, the extraction of coal—the most abundant energy source in the United States—jumped very sharply in January. Since the imposition of the Arab oil embargo, the attractiveness of coal as an alternate source of energy has increased substantially. Several utilities along the Eastern Seaboard have been granted permission to burn coal instead of residual oil, which is in short supply. However, the index of coal output tends to be quite volatile on a month-to-month basis, and the rise early this year only served to return coal output to the approximate level reached in several months of 1973.

New orders placed with manufacturers of durable goods jumped nearly 5 percent in January, on a seasonally adjusted basis, after a drop of more than 6 percent during the previous month. Any assessment of the underlying situation is complicated by the fact that the flow of bookings has been particularly volatile during the recent past. For example, new orders declined during each month of the third quarter, but rose substantially over the next two months. On balance, the overall flow of new orders has remained sizable, with orders in January about 1.3 percent above the June-July 1973 average. During January, a large rise of $1 billion in the very volatile defense orders series was partially offset by a $0.6 billion drop in primary metal bookings. After declining in December, orders for nondefense capital goods rose $0.4 billion in January to a level 5.1 percent above the mid-1973 pace. Meanwhile, the backlog of unfilled orders continued to swell in January, and the very large backlog should serve to bolster production in the near future.

Chart I

INDUSTRIAL PRODUCTION

Seasonally adjusted; 1967=100



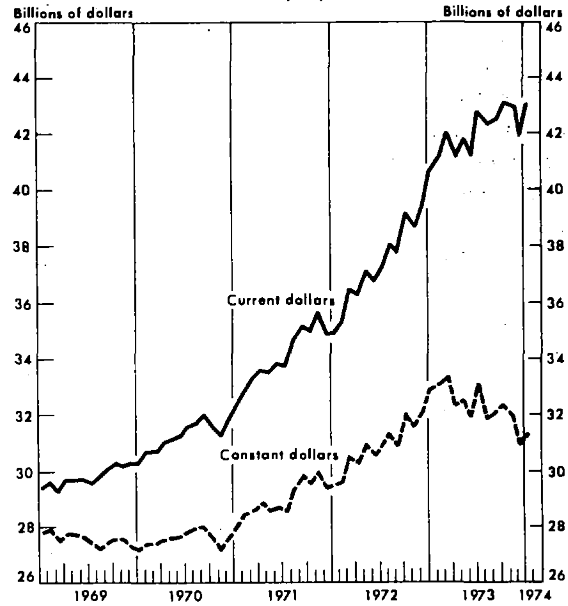
Source: Board of Governors of the Federal Reserve System.

There is recent evidence that capital spending plans for 1974 have strengthened even further. A special survey conducted by McGraw-Hill during late January and early February indicated that businesses are planning to raise their plant and equipment outlays by 18 percent in 1974. This is substantially above the increases of 12 percent to 14 percent previously projected for this year on the basis of surveys conducted in late 1973 by McGraw-Hill, Lionel D. Edie, and the Commerce Department. Moreover, the most recent information suggests that the net effect of the energy situation on capital spending may be positive, even though some sectors have substantially pared their spending plans.

Business inventory spending continued its rapid rise on a book value basis in December, increasing at a seasonally adjusted annual rate of $32 billion after the record shattering $39 billion November rise. As a result, the expansion in total business inventories during the final quarter of 1973 amounted to $32 billion at an annual rate, easily the largest quarterly gain in business inventories since the end of World War II.

Some of the recent climb in inventories represents the undesired buildup of unsold large cars. During both October and November, the dollar value of inventories at retail automotive outlets jumped an average of $6 billion (seasonally adjusted annual rate), but this slowed significantly to a $1½ billion rate of accumulation in December. By the end of January the number of new cars in the hands of dealers had, on a seasonally adjusted basis, been reduced somewhat from the levels reached during the final months of last year. Relative to sales, however, they still remained very high. Preliminary data for February indicate that the seasonally adjusted pace of domestic-type passenger car assemblies was again below that of new car sales, suggesting that a further decline in auto inventories may have taken place. Also it is true that much of the rapid climb in the book value of inventories reflects the extraordinary rates of inflation experienced recently rather than the growth of physical stocks. Nonetheless, a substantial buildup of physical stocks also took place outside the automotive sector toward the end of 1973. As shown in the GNP accounts, the fourth-quarter change in real business inventories—excluding the very large rise in automotive dealers' stocks—was three times as large as the average increase over the first three quarters of the year. Much of this stepped-up spending appears to have been deliberate. For example, approximately half of the unusually steep December climb in the book value of durables manufacturers' inventories consisted of increased holdings of materials and supplies. This was very likely an intentional response to the widespread shortages of materials that plagued firms during much of the recent past.

Chart II
RETAIL SALES
Seasonally adjusted



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

The ratio of inventories to sales for all businesses rose from 1.41 in November to 1.45 in December, largely as a result of the drop in auto sales together with the buildup in auto inventories. Although the December ratio was the highest in 1973, it was still lower than at any time during the 1968-72 period. Moreover, when the automobile sector is excluded, the inventory-sales ratio was lower in December than in some earlier months of the year, suggesting that most inventories remain lean relative to sales volume.

PERSONAL INCOME, CONSUMER DEMAND, AND RESIDENTIAL CONSTUCTION

Personal income declined $4.1 billion in January to a seasonally adjusted annual rate of $1,084.9 billion. This was the first decline in nineteen months and the largest drop since July 1971, when income plunged by $10.1 billion. However, both of these earlier declines reflected mainly once-and-for-all developments. In June 1972, personal income fell mostly because of the aftereffects of tropical storm Agnes, while the earlier drop followed a big lump sum social security payment. Some of the weakness evident in January can be traced to higher social insurance contributions which are deducted from personal income. Much of the recent decline, though, is indicative of the weakening in economic activity. This is seen most clearly in the behavior of wage and salary disbursements. Wage and salary payments dropped $2.7 billion in January after having added an average of $5.7 billion to personal income during each of the preceding twelve months. The January decline was concentrated in manufacturing and construction, where falling employment and shortened workweeks reduced wage and salary payments by $3.5 billion and $1.1 billion, respectively. Farm income also declined by a substantial $2.8 billion as a result of lower subsidy payments under the Agriculture and Consumer Protection Act of 1973.

According to the preliminary estimate, retail sales in January climbed a sizable 2.5 percent above the depressed December level (see Chart II). The January rise in current-dollar sales was the largest in seven months and seemed to be fairly broad based. If this advance estimate holds up under subsequent revisions, the nominal value of retail sales will have climbed slightly above the peak reached last November. However, in real terms, retail sales remain well below the peak level measured last March.

Sales of new domestic-type passenger automobiles slipped a bit further in February to a seasonally adjusted annual rate of 7.4 million units from January's depressed 7.7 million unit pace. During the past several months, sales of domestic autos have receded to the lowest level since the last quarter of 1970, when a strike at General Motors drastically reduced the available supply of domestic passenger cars. It may be too early to tell whether the decline in auto sales, which began with the introduction of the 1974 models and continued with the start of the oil embargo, has just about run its course. However, sales should rise as production shifts yield increased supplies of the popular small vehicles.

Residential construction activity picked up somewhat in January, as housing starts rose 6.1 percent to a seasonally adjusted annual rate of 1.49 million units in comparison with 1.40 million units started in December. While the January pace was still 40 percent below the 2.47 million units started one year earlier, the increase may mark the end of the pronounced downtrend that began in the middle of last year. The recent behavior of building permits also provides some encouragement: newly issued permits jumped 9½ percent in January to the highest rate in several months. The availability of mortgage money has been enhanced by the flow of funds to mutual savings banks and savings and loan associations. Deposit growth at these institutions, which are the major sources of mortgage lending, has strengthened considerably after tapering off dramatically during the summer months. According to preliminary data, seasonally adjusted net deposit inflows were at an annual rate of about 12 percent in January, the fastest pace since the same month a year ago. There is also some indication that inflows remained strong during February.

During December, shipments of mobile homes, which in recent years have represented a substantial portion of the supply of new housing, were at a seasonally adjusted annual rate of 466,000 units, about equal to the average number of shipments over the last several months. Nonetheless, current shipments are sharply below the record level of 737,000 units sold in March 1973. Sales of new single-family homes also fell sharply in December to the slowest pace in three and one-half years, while inventories of unsold homes have shown little change. Consequently, the ratio of unsold homes to sales rose to a record 12.8 months of sales, almost twice the level recorded in the year-earlier period.

PRICES

Inflation continued to intensify during January, as seasonally adjusted wholesale prices rose at a sizzling 38 percent annual rate. Although the rise was only about one half the size of the enormous post-freeze surge registered last August, it was still the second largest monthly increase in wholesale prices in more than a quarter century, underscoring the severity of the current inflation.

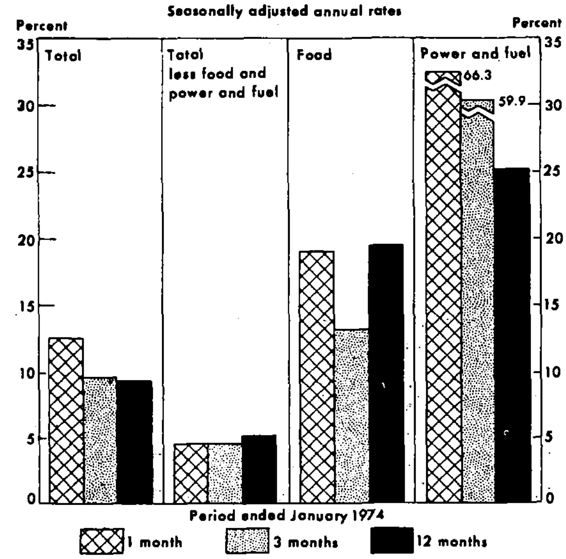
Perhaps the most distressing feature of the January advance in wholesale prices was its pervasiveness. Prices of farm products, processed foods, and feeds jumped at a 61 percent annual rate after declining in three of the four previous months. Over the year ended in January, these prices rose by almost 30 percent. The resurgence of food price pressures is mainly attributable to rising prices of wheat and beef. The realization that stocks of wheat are at low levels has helped push wheat prices up. Beef prices have increased in response to forces set in motion last summer. At that time, farmers reduced the volume of cattle placed on feed for winter marketing in reaction to the price ceilings placed on beef. Ceilings were lifted September 10, but this was too late to affect measurably the supplies currently coming to market.

Meanwhile, fuel and power prices leaped 82 percent at an annual rate in January, mainly because of a huge

Chart III

CHANGES IN CONSUMER PRICES

Seasonally adjusted annual rates



Source: United States Department of Labor, Bureau of Labor Statistics.

increase in the price of crude petroleum (over 260 percent at an annual rate). Since the start of the Arab oil embargo last October, wholesale fuel and power prices have risen at an annual rate of 172 percent, compared with the rise of 25 percent in the year preceding the boycott. While energy price increases dominated the overall industrial commodities index, other industrial prices also climbed very rapidly. Excluding the fuel and power component, wholesale prices of industrial commodities rose at a 22 percent annual rate in January, the largest one-month rise on record. Over the twelve months ended in January, such prices increased 11 percent.

Consumer prices surged ahead at a 12½ percent seasonally adjusted annual rate in January (see Chart III) after rising at a 6½ percent pace in December. Except for the burst last August associated with the lifting of the second price freeze on most foods, this was the largest month-to-month increase in consumer prices since the early days of the Korean war. Advances in the prices of food and energy contributed substantially to the overall increase in consumer prices in January and in the last several months. When these two components were excluded from the index, the consumer price index rose at an annual rate of 4.5 percent in January and at the same rate during the last three months. Over the preceding year the index rose at a 5.1 percent annual rate.

Consumer power and fuel prices continued to soar, rising at an annual rate of 66 percent in January. This component, which includes gasoline, home heating oil, and gas and electricity, has increased more than 50 percent (annual rate) since the start of the oil embargo last October. At the same time, food prices rose at an annual rate of 19 percent in January. This brought the rise over the past year to 20 percent. Based on recent estimates made by the United States Department of Agriculture, food prices are expected to advance substantially in the near future.