The Business Situation

Much of the overall weakness of the economy evident in the early months of 1974 can be attributed to the direct and indirect effects of the Arab oil embargo. While the embargo against the United States was substantially ended on March 19, almost five months after its inception, the latest available business statistics do not yet reflect this development. Recent data on economic activity are mixed. To be sure, in February, industrial production declined for the third consecutive month. However, there were tentative signs of a strengthening in residential construction. In addition, new orders for durable goods rose sizably in February for the second successive month, and the backlog of unfilled orders increased again. Recent capital spending surveys indicate that businessmen have stepped up their capital spending plans for 1974. Finally, sales of new domestic passenger cars steadied during March, and unemployment edged lower.

At the same time, the price situation remains dismal. Wholesale prices, led by a huge rise in prices of industrial commodities, continued to advance at an exceedingly rapid rate in March. Consumer prices rose at more than a 15 percent annual rate in February, bringing the advance in such prices over the year ended in February to 10 percent, the largest such increase in more than twenty-five years.

INDUSTRIAL PRODUCTION, INVENTORIES, AND ORDERS

As measured by the Federal Reserve Board's industrial production index, the output of the nation's factories, mines, and utilities declined at a 7.6 percent seasonally adjusted annual rate in February. Although this drop was somewhat smaller than the declines registered in December and January, it marked the first time in more than three years that output has fallen for three consecutive months. As in the two preceding months, the direct and indirect effects of the Arab oil embargo had a pronounced impact on production. Roughly half of the February decline was attributable to cutbacks in autos and auto supply industries and to reductions in energy output.

The energy component of industrial production includes electric power utilities as well as domestic fuel extraction and processing. During February, total energy output fell more than 15 percent at a seasonally adjusted annual rate, bringing the contraction since October, when the embargo began, to nearly 21 percent on an annual rate basis. Passenger car assemblies fell a bit further in February to a seasonally adjusted annual rate of 6.6 million units, almost a third below the pace of assemblies registered last November when the first effects of the oil embargo were felt. Auto production has undoubtedly been held in check in recent months by capacity limitations on the output of the popular smaller models as well as by the huge stock of slow-selling large cars. During the first half of February, production was additionally retarded by the independent truckers' strike which impeded the delivery of auto parts and materials. However, passenger car output edged up a bit in March to an annual rate of 6.7 million units.

The surge in business inventory spending moderated somewhat in January, as the book value of total business inventories rose at a seasonally adjusted annual rate of nearly $29 billion, in comparison with the record-breaking December increase of $45 billion and the $40 billion November gain. Inventory accumulation during January was still high by historical standards but, as has been the case for many months, a substantial part of the January rise represents the impact of very rapid rates of inflation on book values rather than rising physical stocks.

Virtually all of the January increase in business inventories occurred in the manufacturing and wholesale sectors. Retail inventories rose at only a $1.7 billion annual rate in January, a marked slowing from the $10.9 billion rate of accumulation averaged over the previous three months. A major reason for this slowdown was a halt in the undesired buildup of stocks at retail automotive outlets. Measured in unit terms, the number of unsold new cars peaked at a seasonally adjusted 1.84 million autos last November and subsequently fell to 1.63 million units by February. Despite this substantial reduction, auto inventories remain high relative to the low rate of sales.

At the February sales pace, dealer supplies of new cars equaled sixty-eight days of sales, compared with the forty-seven days' supply in stock during the first nine months of 1973 when new car sales were brisk. In terms of both units on hand and days' supply, new car inventories probably fell in March as sales exceeded production during the month.

For all businesses, the ratio of inventories to sales dropped from 1.46 in December to 1.43 in January, thus putting the ratio only slightly above the post-Korean war low of last November. The latest decline was in part the result of a strong rebound in business sales in January following the decline recorded in the previous month. Furthermore, when autos are excluded, the January inventory-sales ratio was the lowest on record, giving no indication of excess stocks outside the automotive sector.

The seasonally adjusted flow of new orders placed with manufacturers of durable goods rose sharply in February, the second consecutive month in which bookings have increased by more than 2 percent. Although these gains indicate a firm rebound from the sharp, auto-related decline of 6 percent in December, bookings still have not returned to the peak attained last November. Excluding transportation equipment, however, new orders in February were about 2½ percent above their November pace. An interesting feature of the February advance is that it was not dependent on an increase in the volatile defense orders series. In January, higher defense bookings accounted for all of the increase in durables orders, but in February such orders declined by $0.3 billion while the total rose by $1 billion. Perhaps most significant is the fact that orders for nondefense capital goods increased by $0.7 billion, or about 6 percent, in February. This is the largest rise in seventeen months and is in keeping with the latest capital spending surveys which project sizable increases in expenditures during 1974. Moreover, backlogs of unfilled orders continued to mount and by February stood 5 percent above last November.

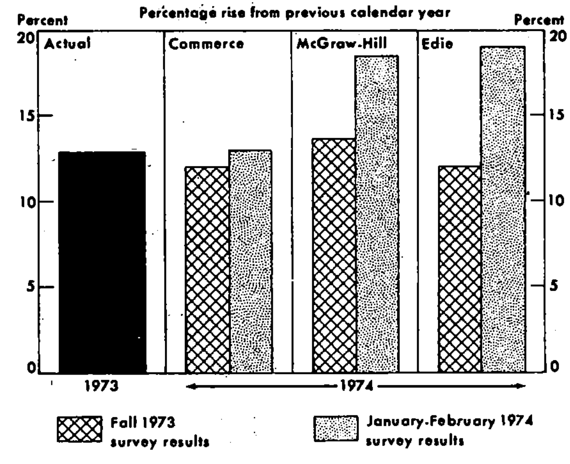
According to the most recent Commerce Department survey—conducted during late January and early February—businesses plan to increase expenditures on plant and equipment by 13 percent during 1974. This is about equal to the actual increase during 1973 and is 1 percent more than was indicated in the fall Commerce survey (see Chart I). Even more bullish estimates of capital spending in 1974 were obtained from surveys, taken at about the same time, by Lionel D. Edie and McGraw-Hill. These surveys revealed a roughly 19 percent increase in capital outlays planned for 1974. The differences between the results of these surveys may be accounted for by the fact that both the McGraw-Hill and Edie samples are weighted more heavily toward large firms than is the Commerce survey. In any event, the Edie and McGraw-Hill results constitute a substantial upward revision from their earlier estimates of a 12 percent to 14 percent increase in capital spending during 1974. On balance, these figures suggest that the energy shortage has had a positive effect on business fixed investment plans. The McGraw-Hill survey indicates a large increase in spending by the energy-supplying industries. The petroleum industry expects to double its expenditures relative to the increase planned earlier, while the electric utilities have plans to increase capital spending 18 percent, up from the 14 percent rise reported earlier. On the other hand, many energy-consuming industries have pared their spending plans. Both the auto industry and the trucking companies have substantially scaled back their capital spending plans for 1974.

Chart I

PLANT AND EQUIPMENT SPENDING SURVEYS

PLANNED SPENDING IN 1974

Percentage rise from previous calendar year



Sources: United States Department of Commerce, Bureau of Economic Analysis; McGraw-Hill, Inc.; and Lionel D. Edie & Company Incorporated.

PERSONAL INCOME, CONSUMER DEMAND, AND RESIDENTIAL CONSTRUCTION

Personal income advanced $6.6 billion in February to a seasonally adjusted annual rate of $1,093.6 billion. Even though this rise is rather modest when compared with the average monthly gain of $8.8 billion in 1973, it does represent a rebound from the $2 billion drop in January. About half of the February advance was concentrated in private wage and salary disbursements, which rose $3.2 billion largely as a result of increases in payroll employment, the average workweek, and hourly earnings. In comparison, wages and salaries had fallen $1.7 billion the month before. However, wage and salary payments in the manufacturing sector remained unchanged in February, after declining by $2.1 billion in January. Energy-induced layoffs pared the number of workers on factory payrolls in both January and February, but the sharp January drop in the length of the manufacturing workweek was followed by a substantial rebound in February.

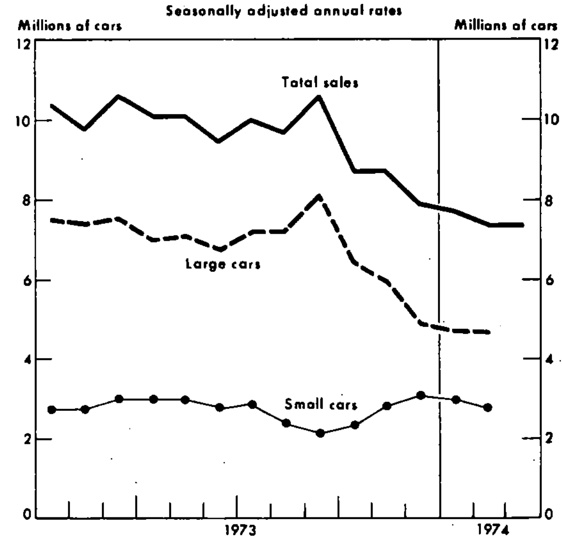
Consumer spending remains on the sluggish side. According to the revised estimate for February, total retail sales edged up only 0.2 percent above the January level. As in recent months, declining purchases at retail automotive outlets restrained the growth of retail sales. When the automotive group is excluded from the total, retail sales rose more than 1 percent above the January figure. However, measured in current-dollar terms, total retail sales in February remained below the peak reached last October and, when stripped of price increases, they were probably at their lowest level since late 1972.

Following three consecutive monthly declines, sales of new domestic-type passenger cars held steady in March at a seasonally adjusted annual rate of 7.4 million units (see Chart II), suggesting that perhaps the weakness in auto sales has bottomed out. The significance of the March figures is somewhat difficult to assess, however, because intense sales contests were reportedly under way during the month. The persistent decline in auto sales prior to March was largely the result of the slump in purchases of standard-size models. Large car sales fell from a peak seasonally adjusted annual rate of 8.1 million units in September to 4.7 million units in February. Much, but not all, of this decline can be traced to the Arab oil embargo and the associated uncertainties, particularly with respect to the cost and availability of gasoline. It is, of course, too early to determine whether the lifting of the embargo will stimulate sales of large cars or if a more permanent change in consumer preferences has taken place. Meanwhile, the demand for small domestic-type cars has remained buoyant. Sales of such models rose from a seasonally adjusted annual rate of 2.1 million units in September to a peak of 3.1 million units in December; such sales totaled 2.7 million units in February. According to industry observers, small car sales would have been considerably higher in recent months if supply had been able to keep up with demand. By way of perspective, the share of small cars as a percentage of domestic auto sales has risen markedly from an average of 27 percent over the first three quarters of 1973 to a

Chart II

SALES OF NEW DOMESTIC-TYPE PASSENGER CARS

Seasonally adjusted annual rates



Source: Board of Governors of the Federal Reserve System.

peak of 39 percent in December and January and 36 percent in February of this year. Over the same period, the share of total new car sales accounted for by imports, which are mostly small cars, has also increased.

Residential construction activity showed further signs of strengthening in February, but the duration and magnitude of this rebound are highly uncertain. Housing starts rose in February for the second successive month, climbing 22 percent to a seasonally adjusted annual rate of 1.8 million units; hence, starts have risen well above their recent low of 1.4 million units posted last December. However, the size of the February increase—the largest one-month percentage rise on record—may be somewhat of a statistical quirk. In contrast to the sharp spurt in starts, newly issued building permits remained essentially unchanged in February at a seasonally adjusted annual rate of 1.3 million units, a little more than 5 percent above the depressed rate reached last December.

Deliveries of mobile homes edged up slightly in January to a seasonally adjusted annual rate of 469,000 units, but they remain more than a third below the record pace reached early in 1973. Sales of new single-family homes picked up a bit in January, too, after declining sharply in the previous month. At the same time, inventories of unsold homes have remained virtually unchanged. Consequently, the ratio of unsold homes to sales declined slightly from the record 12.2 months of sales posted in December to a still high 11.8 months of sales in January. Substantial quantities of unsold homes may serve to restrain construction in the future. Moreover, with market rates of interest increasing considerably, the availability of mortgage funds at thrift institutions may become scarce once again.

PRICE DEVELOPMENTS

The latest data indicate that prices continue to rise at extraordinarily rapid rates. Although wholesale agricultural prices registered a fairly broad-based decline during March, some observers fear this development could be reversed in coming months. Moreover, the extreme volatility exhibited during the past year or so by agricultural prices makes it difficult to assess the significance of month-to-month changes in such prices. Energy prices have tended to dominate the behavior of the industrial component of wholesale prices in recent months. During March, wholesale power and fuel prices soared at an annual rate of 58 percent, bringing the rise over the past half year to an astounding 121 percent at an annual rate. Even more disturbing, however, is the behavior of nonenergy industrial prices. Excluding power and fuel, wholesale industrial prices climbed more than 30 percent at an annual rate in March, the largest one-month burst on record, compared with a rise of 14 percent over the span of the preceding four months and an advance of 7½ percent over the year ended last October.

Consumer prices surged at a seasonally adjusted annual rate of 15½ percent in February, the second largest monthly increase since the Korean war. Moreover, the increase in consumer prices over the year ended in February equaled 10 percent, the most rapid annual increase in consumer prices in more than twenty-five years. As in recent months, the jump in consumer prices in February was led by rising food and energy prices. Food prices climbed at more than a 30 percent seasonally adjusted annual rate in February. Such prices had been anticipated to rise very rapidly during the early part of 1974, but the February advance was probably exacerbated by the independent truckers' strike which reduced supplies of foodstuffs in some areas of the country during the first half of the month. Consumer power and fuel prices also continued to soar in February, rising at a 51 percent seasonally adjusted annual rate. Prices of gasoline and motor oil led the surge. Since the start of the embargo last October, retail gasoline prices alone have risen at an annual rate in excess of 100 percent.

THE LABOR MARKET

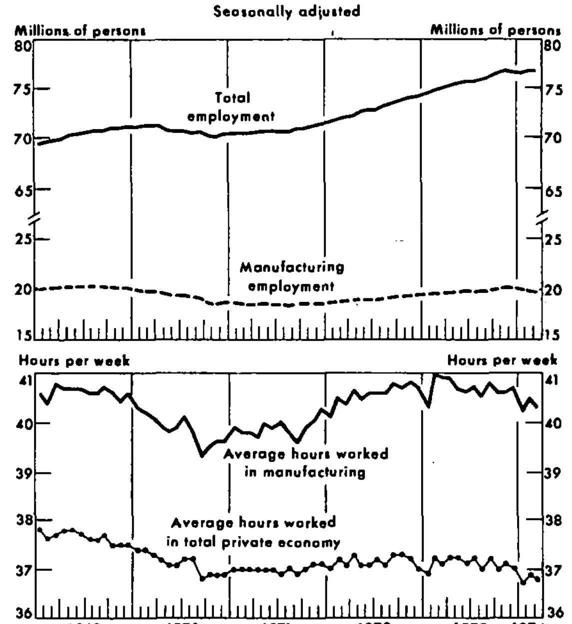
After rising from the 3½-year low of 4.6 percent reached last October to 5.2 percent in January and February, the seasonally adjusted unemployment rate slipped to 5.1 percent in March, according to the monthly household survey. During March, the number of unemployed persons averaged 4.6 million, a half-million higher than the level reached in October. The civilian labor force was essentially unchanged in March for the second consecutive month at 90.5 million persons, following the very sharp rise recorded in January. While monthly and even quarterly changes in the size of the labor force tend to be quite volatile, the labor force has grown very rapidly during the past year or so. Over the four quarters ended in March, the labor force grew by 2.9 million persons, or 3.3 percent. This is much faster than the 1.8 percent increase in the size of the noninstitutional working age population.

The Labor Department survey of establishments revealed that the number of persons on nonagricultural payrolls declined by 125,000 in March. After falling in January and rising in February, nonfarm payroll employ-

Chart III

NONFARM PAYROLL EMPLOYMENT AND HOURS WORKED

Seasonally adjusted



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

ment in March stood at about the same level as in November and December of last year (see Chart III). Manufacturing employment has fallen steadily over the past few months and by March was 315,000 persons below the peak reached last November. A further decline in employment in the transportation equipment industry accounted for almost half the March drop in overall factory employment and brought to 200,000 the cumulative employment decline in this sector since November.

There is little doubt that the energy shortage has exerted a substantial adverse impact on unemployment in recent months. The Bureau of Labor Statistics compiles information on the distribution of the unemployed by reason of joblessness. These data indicate that all of the increase in joblessness since October has been among persons who lost their last jobs. The number of people unemployed because they had either left their last job or were new entrants or reentrants into the labor force has not changed appreciably over the past five months. There are some signs, however, that these adverse employment effects may be diminishing. For example, the Labor Department reported that the number of initial claims for unemployment compensation attributable to the energy shortfall under state insurance programs reached a peak of 115,000 during the first full week of February, but slackened to about 45,000 toward the end of March.