The Business Situation

The latest readings of business indicators suggest that the economy continues to drift at the sluggish pace that characterized the second quarter.* On balance, the modest gains recorded in some sectors have been offset by declines in others. Industrial production barely inched ahead in July and was still below the peak attained last November. Activity in the automotive sector picked up a bit in July, as sales and production of new domestic models registered advances. According to the advance report, the rise in auto sales led a substantial increase in July retail sales. Manufacturers continued to accumulate inventories at a rapid rate in July. Capital appropriations spurted in the second quarter, but smaller gains in business spending on plant and equipment are planned for the second half of the year than occurred over the first six months. The situation in the residential housing market deteriorated further in July, reflecting rising interest rates and the increasing scarcity of mortgage funds.

Despite the sluggishness of the economy, the price situation remains unrelentingly dismal. Prices of wholesale industrial and consumer nonfood commodities have continued to advance at excessively rapid rates. Evidently, these increases are largely the result of concurrent and past hikes in labor and materials costs, although to some extent the inflation may still reflect the end of price controls. In any event, the price outlook has been dealt yet another blow from the drought in the Midwest and sharp rises in the wholesale prices of grains and meats have already surfaced.

*The revised second-quarter estimates indicate that gross national product (GNP) rose $28.5 billion, or at a seasonally adjusted annual rate of 8.7 percent. The rate of increase in the implicit GNP deflator was revised upward slightly to 9.6 percent per annum, and the rate of decline in real GNP was revised to 0.8 percent. According to the preliminary estimates released along with the GNP revisions, pretax corporate profits were reported to have risen $11.7 billion to a seasonally adjusted annual rate of $150.4 billion.

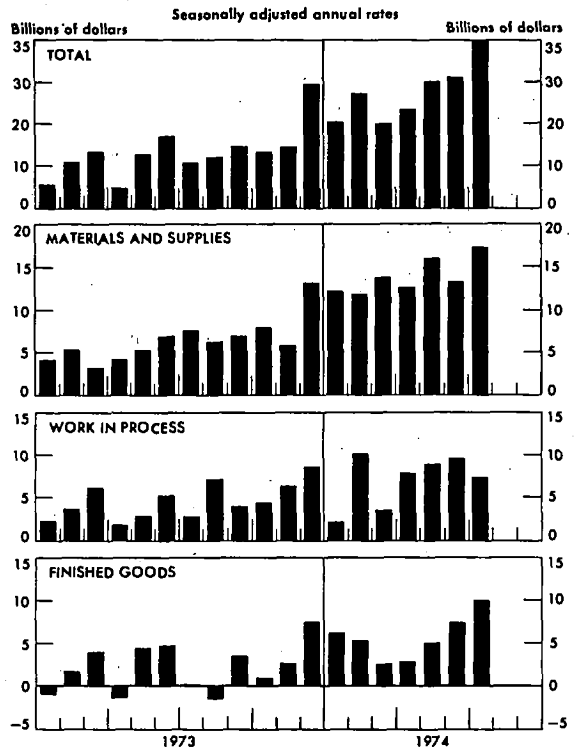
INDUSTRIAL PRODUCTION, RETAIL SALES, ORDERS, AND INVENTORIES

The Federal Reserve Board's index of industrial production inched ahead at a seasonally adjusted annual rate of 1 percent in July, offsetting the decline of the previous month. Energy production continued to rebound in July and has climbed 10 percent at an annual rate since reaching its recent low in March. Production of consumer goods also rose modestly in July, while production of construction materials declined in response to the slowdown in residential building. Production of business equipment was unchanged, remaining close to the peak reached in May.

Following the sharp energy-shortage-related contraction in the opening months of the year, the recovery in industrial production has proceeded at a slow pace. Between March and July, output has grown at an average 2.4 percent annual rate. There is a possibility that in coming months energy shortages may again occur. For instance, in a recent announcement, the Federal Energy Administration projected some natural gas shortages this winter. Of course, the importance of natural gas shortages on economic activity will depend on a number of unknown factors, such as the severity of winter weather and the economy's ability to substitute alternative energy sources. The availability of at least one alternate energy source, coal, seems questionable inasmuch as the United Mine Workers contract expires in November. With coal inventories already low in the steel and utilities industries, a lengthy strike could bear heavily on economic activity. As a bargaining device, the mine workers already have employed "memorial" work stoppages that reduced coal production. In addition to these possible energy problems, the oil situation continues to be uncertain. Several member nations of the Organization of Petroleum Exporting Countries have recently announced production cutbacks in an attempt to support oil prices in the face of a growing world surplus of crude oil.

Chart I

CHANGES IN MANUFACTURERS' INVENTORIES BY STAGE OF FABRICATION



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

The automotive sector recorded further modest gains in July. Production of domestic passenger cars rose 1.3 percent in that month to an annual rate of 7.8 million units, the highest reading this year but still below any monthly figure for the 1971-73 interval. Continued strike activity at General Motors apparently served to hold output below the 8.5 million units scheduled for the month. In any event, new car assemblies in July were nearly 25 percent below those of a year earlier. Sales of new domestic-type cars increased in July to an annual rate of 8.2 million units, the most rapid sales pace since late last year. Continuing the trend which emerged after the termination of the Arab oil embargo, large cars accounted for an increased share of domestic auto sales in July.

According to the advance report, automotive sales accounted for more than two fifths of the substantial July rise in total retail sales, which is estimated at 4 percent (not an annual rate). Sales of other consumer durables rose moderately, while sales of nondurables posted a sizable 2.9 percent advance for the month.

New orders received by durable goods manufacturers rose in July by $1.01 billion, or 2.2 percent, about equal to the growth averaged over the first six months of this year. The July gain resulted totally from a large jump in orders in the transportation-equipment sector, due mainly to higher auto orders. However, these data are difficult to interpret precisely because the timing of the summer model changeover period complicates seasonal adjustment procedures. Excluding the transportation sector, new orders for durable goods in July fell 1.6 percent, led by a decline in bookings for primary metals. Although shipments of durable goods picked up sharply in July, the backlog of unfilled orders continued to climb, reaching a level 31.5 percent above the total of the corresponding month of last year.

The book value of manufacturers' inventories increased sharply in July, rising at a seasonally adjusted annual rate of $35 billion (see Chart I). This was the largest increase in the current inventory buildup that began in December; over the December-July period, manufacturers have added an average $27 billion to their inventories. Despite the large increase in inventories in July, shipments rose at even a faster pace and the inventory-sales ratio in this sector declined to 1.62 months of shipments from 1.65. However, because of accounting practices, the change in book value of inventories, unlike shipments, only partially reflects the effect of spiraling prices. As a consequence, it is difficult to interpret whether the inventory buildup represents desired or unintended accumulation. Examining inventories by stage of fabrication suggests that finished goods are beginning to account for a larger portion of the increase in total inventories. While the bulk of July's increase continued to be in materials and supplies and work in process, finished goods inventories rose at a $10 billion annual rate in that month, substantially above the $5.6 billion rate of accumulation averaged since December.

CAPITAL SPENDING

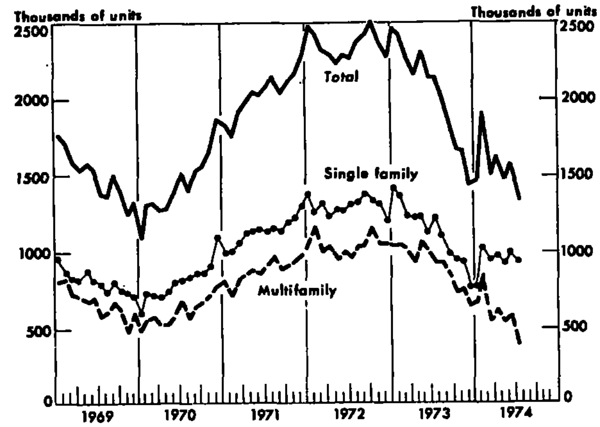
According to the Commerce Department survey taken in July and August, business spending on new plant and equipment is now expected to rise 12.5 percent in 1974, slightly above the planned 12.2 percent increase indicated in the earlier survey. Over the first half of 1974, actual plant and equipment outlays are estimated to have risen $7.7 billion, or 14.8 percent at a seasonally adjusted annual rate, slightly above the gain expected in the earlier Commerce survey. However, as indicated in the earlier survey, smaller increases are planned for the second half of the year. A special survey taken by the Commerce Department in late 1973 indicated that spending on airand water-pollution-abatement equipment represented approximately one sixth of the planned increase in capital expenditures of all industries. At that time, planned antipollution expenditures represented more than 20 percent of the capital budgets of the nonferrous metals, iron and steel, and paper industries. Thus, taking into account pollution-abatement expenditures and the impact of inflation, the growth of the productive capacity of many industries will be considerably less than that indicated by total planned outlays in current dollars. Over the second half of 1974, nonmanufacturing outlays are expected to grow only modestly, with utilities and railroads paring earlier planned expenditures.

As reported by the Conference Board's survey of large manufacturers, capital appropriations jumped a sizzling 39 percent (not an annual rate) in the second quarter, with the increase concentrated in nondurable goods manufacturers, especially materials-producing industries. Leading the advance were increased appropriations in the petroleum, nonferrous metals, paper, and chemical industries. Since the change in appropriations reflects both changes in prices and planned real spending, the Conference Board has developed data that exclude the effect of inflation. In constant dollar terms, new appropriations rose a substantial 33 percent in the second quarter, and the backlog of unspent appropriations climbed 14 percent. Of course, appropriations may be canceled, and the timing of the planned expenditures is uncertain. Nevertheless, the size of the advance in new appropriations and backlogs in constant dollars suggests that increased business spending on new plant and equipment may be in the offing.

Chart II

HOUSING STARTS

Seasonally adjusted annual rate



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

RESIDENTIAL CONSTRUCTION

Residential building activity slumped further in July under the pressures of high interest rates, escalating construction costs, and the scarcity of mortgage money. On a seasonally adjusted annual rate basis, housing starts fell to 1.3 million units in July, down almost 38 percent from a year earlier and the lowest level in over four years. While the entire residential construction sector has lately been depressed, multifamily units have been particularly hard hit (see Chart II). In July, multifamily starts amounted to 394,000 units at an annual rate, more than 57 percent below the level in the corresponding month of last year. In part, this decrease reflects a weakening in the demand for both rental and condominium apartments. In the second quarter, for example, the rental vacancy rate stood at a six-year high of 6.3 percent. Moreover, the availability of multiunit construction loans has been squeezed by the deteriorating financial position of real estate investment trusts, which supplied about 10 percent of all multifamily lending in 1973.

High market rates of interest have served to restrict the availability of mortgage money, as savers have channeled funds to instruments such as money market mutual funds, variable-rate notes of bank holding companies, and Treasury securities. Deposits at thrift institutions, seasonally adjusted, grew at only a 1.2 percent annual rate in July, the lowest rate since January 1970 and well below the 6.3 percent gain averaged in the first six months of the year. Over the three months ended in July, thrift deposits grew at a scant 3.2 percent annual rate. Mutual savings banks have been particularly hard hit, losing deposits on a seasonally adjusted basis in July for the third time in the past four months. In view of this slowdown in deposit flows, both savings and loan associations and mutual savings banks have become increasingly reluctant to make new mortgage commitments. In fact, outstanding mortgage commitments, seasonally adjusted, at savings and loan associations and New York State mutual savings banks have declined $2.6 billion, or 13 percent, since April.

By any measure, mortgage market interest rates have skyrocketed. In the Federal National Mortgage Association's (FNMA) August 26 auction, the yield on four-month FNMA commitments to purchase Government-insured mortgages rose to a record high of 10.38 percent, up 168 basis points from the January 1974 auction. In the primary mortgage market, rates also continued to soar.

In an attempt to remain competitive with conventional mortgages rates, the ceiling rate on Government-insured mortgages was raised 50 basis points in August to a record high of 9.50 percent. This marked the fourth time in five months that the ceiling on interest rates of mortgages insured by the Federal Housing Administration (FHA) and guaranteed by the Veterans Administration (VA) was raised. Moreover, prospective home buyers reportedly are facing even higher rates as the rates on mortgage commitments continue to rise.

Sales of single-family homes slowed to a seasonally adjusted annual rate of 539,000 units in June, down from the 598,000 units reached in May. The backlog of homes for sale remained virtually unchanged at 434,000 units. However, the median time that this inventory of homes has been on the market, as measured from ground breaking, rose to 8.3 months in June, from 7.6 months in May and the 6.2 months averaged in the first quarter. The seasonally adjusted ratio of homes available for sale to homes sold rose to 9.9 months of sales in June. Despite this weakening in sales, prices of new homes continued to advance. As measured by the Bureau of the Census index, the price of new one-family homes sold rose at a 13.2 percent annual rate in the second quarter, compared with a 7.6 percent increase in the first quarter and 10.5 percent in 1973. Shipments of mobile homes, which tended to hold up in previous housing downturns, declined in June to an annual rate of 441,000 units, well below the 600,000 units shipped a year ago.

Last May, the Federal Government announced an emergency housing program that was to provide up to $10.3 billion to the mortgage market. Thus far, it appears that this program has not had much impact, despite the strong reaction to the Federal Home Loan Mortgage Corporation's forward commitment program. Builders' response to the Government National Mortgage Association (GNMA) Tandem Plan has been quite slow, possibly because of the delays involved in obtaining FHA or VA approval. While activity appears to have picked up somewhat recently, GNMA still has unused authorization to purchase below-market-rate mortgages on about 175,000 units. Furthermore, it appears that savings and loan associations may be hesitating to add the subsidized Federal Home Loan Bank (FHLB) five-year advances provided by the emergency program to their already high borrowings from the FHLBs.

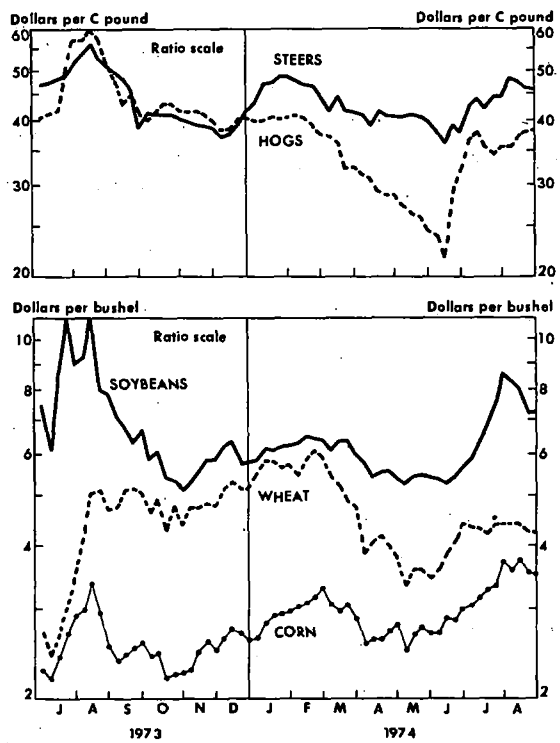
Regardless of the extent to which this program is utilized, it is not clear whether it will bring additional funds to the mortgage market or merely replace flows that otherwise would have occurred. A number of additional innovations are being proposed or instituted. New FHLB regulations allow member thrift institutions to issue large-denomination negotiable certificates of deposit; however, there is little evidence of aggressive bidding for funds by the thrift institutions. Most recently, the FHLB Board has proposed regulations that allow variable-rate mortgages, and legislation has just been passed in the Congress to raise the ceiling on Government-insured mortgages to $45,000. In addition, one large mutual savings bank, following the lead of several bank holding companies, has recently issued a variable-rate bond to raise funds.

PRICE DEVELOPMENTS

Inflation remains severe. According to the latest data, prices of wholesale industrial and consumer nonfood commodities have continued to advance at extremely rapid rates. As the termination date of price controls recedes further into the past, it becomes increasingly difficult to attribute price hikes to a post-controls bulge. Instead,

Chart III

SPOT PRICES FOR SELECTED AGRICULTURAL COMMODITIES



Source: The Wall Street Journal.

recent price increases appear to be the result of current and past rises in labor costs and in raw materials prices. Moreover, a resurgence in feed grain prices, which has already become visible at the spot and wholesale levels, suggests that there will be large increases in retail food prices in coming months.

Seasonally adjusted consumer prices climbed at a 9.1 percent annual rate in July, only the second time this year that the rate of increase was below 10 percent. However, almost all of the slowdown was the result of an outright decline in retail food prices, which may shortly be reversed. Apart from food prices, consumers continued to face stiff price hikes. Prices of consumer nonfood commodities, for instance, climbed at nearly a 16 percent annual rate in July, up slightly from the 15 percent rate of advance averaged in earlier months of the year. A sharp rise in the cost of medical care and household services resulted in a 12.7 percent increase in services prices.

In July, wholesale prices skyrocketed at a seasonally adjusted annual rate of 44.6 percent. With large increases being recorded in all sectors, the advance was the most rapid since August 1973. Industrial wholesale prices climbed at a 32.9 percent annual rate in July, or 6 percentage points higher than in the previous month. Higher materials costs contributed significantly to the increase, as prices for paper and metals registered substantial gains. In addition, previous slowdowns in the rate of growth in wholesale fuel and power prices were reversed. In July, energy prices rose at a 68.7 percent annual rate, bringing the increase over the last year to nearly 65 percent. Meanwhile, wholesale farm and feed prices rose at a 77.3 percent annual rate in July, thereby reversing four consecutive monthly declines. While most farm products prices moved higher, increases in prices of livestock and feed grains were particularly large. Early in July, cattlemen countered previous declines in beef prices by temporarily reducing marketings. At about the same time, prices for feed grains began to increase as forecasts of a record corn crop appeared less certain.

Over the four weeks ended August 27, the Bureau of Labor Statistics spot price index of basic commodities declined by 4.5 percent. Prices of raw industrial commodities fell, primarily as a result of a weakening in the price of scrap copper. Prices of raw foodstuffs posted declines over the last two weeks of August after advancing for eight of the previous nine weeks. Over this period, the increases in spot prices of feed grains were especially large. A severe drought which gripped the nation's Corn Belt caused the Agriculture Department to revise its estimates for the 1974 corn crop from 6.7 billion bushels to 5 billion, with smaller year-over-year declines in the projected 1974 crops of soybeans and other grains. In reaction, prices of corn and related feed grains soared. During July and the first part of August, for example, spot corn rose by 72 cents per bushel to $3.74 per bushel, although most recently corn prices have weakened somewhat (see Chart III). With near and distant future prices rising by large amounts, higher prices for several final products seem almost certain. Pork, poultry, eggs, and milk especially will be affected, as total feed costs including protein supplements rise. Despite the higher feed prices, however, beef prices may not climb significantly because of increased marketings of the large number of cattle on pasture.