The Business Situation

Recent economic news indicates some further weakening in business activity.* In October, after months of comparative stability, industrial production posted a sharp, widely based decline, and the automobile industry made substantial layoffs in November and scheduled further cuts for December. New orders for durable manufactured goods fell somewhat further in October, and the backlog of unfilled durables orders dropped for the first time in over three years. Moreover, recent surveys of plant and equipment spending planned for 1975 suggest little or no increase, and quite possibly a decline, in real terms, from capital spending in 1974. Retail sales have continued to weaken, and home building remains depressed. Reflecting the slump in business activity, the unemployment rate jumped to 6.5 percent in November.

Despite the reduction of demand pressures, severe inflation persists. There are, however, some tentative signs that the slowdown in economic activity may be beginning to have an impact on prices at the wholesale and retail levels. While food prices have begun to climb again, the prices of commodities other than food have lately grown at significantly slower rates. Industrial wholesale prices increased at a 13.4 percent annual rate in October, about equal to the September rise but well below the almost 33 percent annual-rate increase averaged during the first eight months of the year. At the retail level, prices of nonfood commodities rose at a 6.8 percent annual rate in October, the smallest advance in a year.

* The revised third-quarter estimates indicate that the gross national product (GNP) increased at a seasonally adjusted annual rate of 9.4 percent. The rate of growth of the implicit price deflator was revised upward to 11.8 percent per annum, and the rate of decline of real GNP was estimated to be 2.1 percent. According to the preliminary estimate released with the GNP revisions, pretax corporate profits were reported to have grown $1.1 billion to a seasonally adjusted annual rate of $106.7 billion.

INDUSTRIAL PRODUCTION

Industrial production declined at a 6.7 percent annual rate in October. In the previous eight months, the output of the nation's factories, utilities, and mines had been fairly stable, having even recovered somewhat from the sharp drop induced by the oil embargo last winter. However, the October decline put the level of production below the third-quarter average and 2 percent below the November 1973 peak. Decreases in output in October occurred in nonautomotive consumer durables, construction materials, and a wide range of other durable and nondurable materials. At the same time, however, business equipment output edged up and steel production remained high, possibly in anticipation of the coal workers' strike.

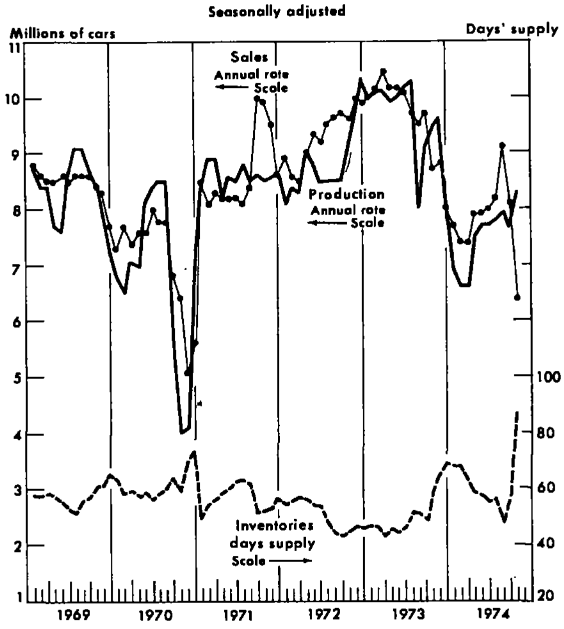
The strike by members of the United Mine Workers union, which began on November 12, undoubtedly had an adverse impact on industrial production in November. Within a week of the strike's onset, steel mill output had begun to slow down. Subsequently, layoffs were announced by the major steel companies, and total steel production fell 12.5 percent in the four weeks ended December 7. The effect of the four-week strike on other coal-dependent industries was probably minimized by stockpiling and the already slow rates of production.

In the automotive industry, scheduled production cuts for November and December reflect the dramatic fall in new car sales and the existence of large stocks of unsold cars. Auto manufacturers misjudged demand for new 1975 models in October, producing at an annual rate of 8.3 million units while sales dropped off to an annual rate of 6.4 million units (see Chart I). As a result, inventories of auto dealers jumped from an average fifty-eight days' supply in September to eighty-seven days' supply in October. In response, all four United States automotive manufacturers drastically reduced production plans for November and December.

Chart I

AUTOMOBILE PRODUCTON, SALES, AND INVENTORIES

Seasonally adjusted



Source: Board of Governors of the Federal Reserve System.

CAPITAL SPENDING, DURABLES ORDERS, AND INVENTORIES

Appropriations for new plant and equipment by the nation's 1,000 largest manufacturers advanced by 8.5 percent in the third quarter, according to preliminary estimates by The Conference Board, Inc. However, excluding the capacity-short petroleum industry, the third-quarter rise was only 4.6 percent, and the Conference Board estimates that inflation accounted for almost all of this increase. For the economy as a whole, the McGraw-Hill survey of anticipated outlays on plant and equipment projects a 12 percent rise in 1975, about the same as this year. However, if realized, the survey also reports that these plans amount to little, if any, change in real terms. Moreover, planned expenditures on plant and equipment in 1974 have already been pared, according to the latest survey conducted by the Department of Commerce. The projected increase in outlays in the fourth quarter is now placed at 0.4 percent, significantly lower than the August survey estimate of 2.8 percent.

Preliminary data indicate that new orders for durable manufactured goods fell in October by $1.1 billion, after dropping by $3.1 billion in September. Most of the decline over the last two months occurred in the capital goods industry, but bookings in all sectors, including primary metals and transportation equipment, are significantly below their August levels. Unfilled orders of durables, which have probably cushioned the drop in production in recent months, fell in October for the first time in almost three and one-half years; the 1 percent decline was widespread. The latest survey conducted by the National Association of Purchasing Management, Inc., indicates a continued weakening in new orders in November. Declining orders were noted by 48 percent of those reporting in November, up from 39 percent in October and the largest percentage in twenty-six years.

In September, manufacturing and trade inventories rose by a sizable $4.5 billion, little changed from the advances recorded in the last four months. Coupled with a slight fall in business sales, this resulted in a sharp jump in the ratio of the book value of manufacturing and trade inventories to sales. Although the level of the current inventory-sales ratio does not appear to be very high by historical standards, two factors suggest that stocks may be somewhat more excessive than indicated by this ratio. First, the ratio of book-value inventories to manufacturing and trade sales is an underestimate of the true inventory-sales ratio during inflationary periods, because much of the book value of inventories is valued in terms of past prices while sales are valued more nearly in terms of current market prices. Second, the composition of recent inventory gains tends to suggest some unintended inventory accumulation: the accumulation of finished goods inventories accounted for 41 percent of the total change in manufacturers' inventories in September, contrasting sharply with the 27 percent average over the previous three months. In October, the portion of finished goods to total manufacturers' inventory accumulation remained at 41 percent.

PERSONAL INCOME, RETAIL SALES, AND RESIDENTIAL CONSTRUCTION

Personal income rose by $8.4 billion in October, about the same rate of total increase as over the past year. However, in the private sector, wage and salary gains slowed substantially, moving up by only $2.8 billion at an annual rate in contrast to a $5.7 billion advance in September. Manufacturing payrolls alone rose by $1.7 billion, as increases in average hourly earnings offset declines in employment and the average workweek. At the same time that income growth in the private sector began to lag, the implementation of a pay raise for Federal Government employees added $2.1 billion to the increase in personal income.

Consumer spending continued at a sluggish pace. According to the advance report, retail sales fell by 0.4 percent in October, following a larger 2.1 percent drop in September. In real terms, sales have been weakening for some time. Indeed, as of October 1974, constant-dollar retail sales were 6 percent below what they had been a year earlier. Declines in real disposable income and general economic uncertainties have made the consumer wary. The index of consumer sentiment prepared by the University of Michigan fell to 64.5 percent in the third quarter. This was about the same level as in the first quarter of 1974, when fears associated with the oil embargo pushed the index to the lowest point in the twenty-eight-year history of the Michigan survey.

The slump in auto sales more than accounted for the October decline in retail sales. According to the Michigan survey, auto buying has been hurt by widespread awareness of record price increases. Moreover, the cost of financing purchases of autos has continued to rise: the finance rate charged consumers by major automotive finance companies, as published by the Board of Governors of the Federal Reserve System, averaged 14.03 percent in September, up from 13.82 percent in August and 13.45 percent in September 1973.

Residential construction remains at depressed levels. In October, housing starts edged down to a seasonally adjusted annual rate of 1.1 million units, little changed since August but 32.9 percent below a year ago. Total permits for new housing units fell 2.6 percent during October to a seasonally adjusted annual rate of 802,000 units, the seventh straight monthly decline. Rapid increases in the prices of homes, low levels of consumer confidence, high mortgage rates, and lack of mortgage money have all contributed to the weakness in the housing sector. Deposit growth at thrift institutions has picked up recently, with inflows to savings and loan associations and mutual savings banks rising by 5.3 percent in October or twice as much as the average for the previous three months. Thrift institutions may concentrate on rebuilding their liquidity over the near term, but continued deposit inflows should eventually lead to improvement in the availability of mortgage funds.

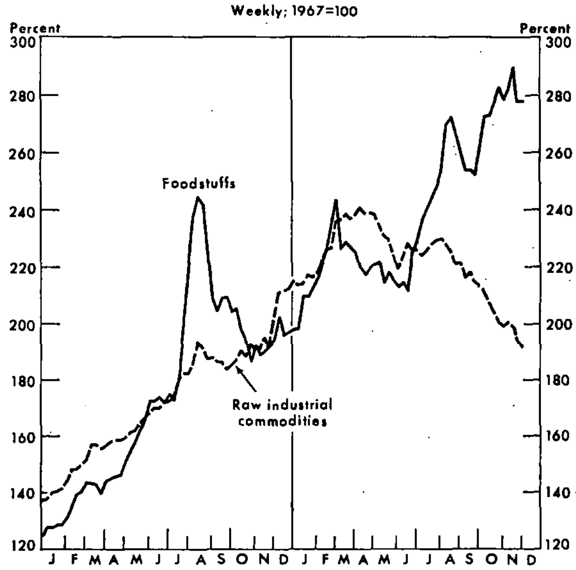
PRICES

Wholesale prices surged ahead in October, bringing the rise over the last twelve months to 22.6 percent, the largest yearly increase since 1947. After edging up at an annual rate of only 1.1 percent in September, the seasonally adjusted index of wholesale prices jumped by 27.9 percent at an annual rate, as food prices resumed their climb. The index for farm products, processed foods, and feeds has moved irregularly upward over the past year to a level 10.6 percent above October 1973, and the trend is expected to continue. However, recent spot prices indicate a slight easing in farm prices in November (see Chart II). The spot price index rose only 0.3 percent from mid-October to mid-November, after rising 10 percent over the previous monthly period.

Industrial commodity prices rose at a 13.4 percent annual rate in October. While high by historical standards, the 13 percent advance in the index over the last two months is considerably less than the 32.9 percent average annual increase in the first eight months of 1974. Moreover, about one third of the October rise is attributable to higher 1975-model car prices. (About two thirds of the average $386 increase in the price per car was included in the wholesale price index, because one third of it was attributed to improvements such as pollution control devices. To the extent that increases in prices of products are traceable to improved quality, that increase is not reflected in the index.)

The slowdown in industrial commodities price increases

Chart II
SPOT COMMODITY PRICES
Weekly; 1967=100

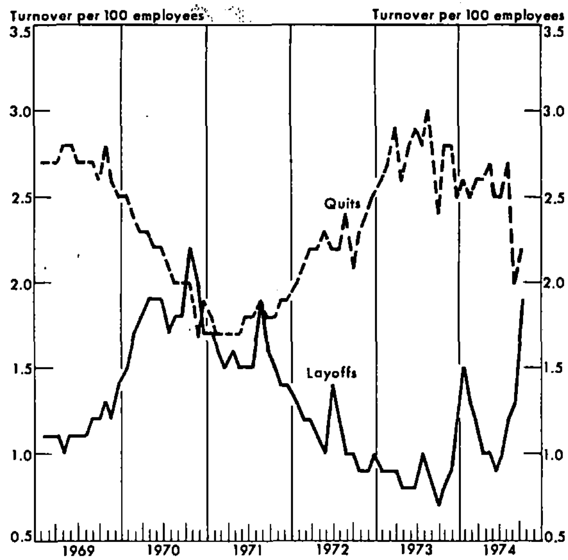


Source: United States Department of Labor, Bureau of Labor Statistics.

reflects, in part, the recent slackening in basic raw materials prices. Over the last three months, the index of crude materials excluding food and feed has risen only 0.2 percent at an annual rate. This compares with an increase in the previous seven months of 1974 of 47.1 percent at an annual rate. However, while raw materials have stabilized in price, the cost of finished goods continues to surge at rates somewhat more than 20 percent on an annual basis. These prices probably reflect previous increases in raw materials prices as well as accelerating wage costs.

Total consumer prices climbed at an annual rate of 10.3 percent in October, down from 15 percent in September and 16 percent in August. While food prices have continued to surge—the food component of the consumer price index rose 16 percent at an annual rate in October as higher prices for sugar, cereal, and bakery products offset declines in meat and poultry prices—the rate of increase in the prices of nonfood commodities has slowed significantly in the last two months. In October, the index of all commodities less food rose 6.8 percent at an annual rate, down substantially from 12 percent in September and an 18.2 percent annual-rate increase in August. Attempts to liquidate finished goods inventories in the face of softening demand may be contributing to the slowing in the rate of price increases. The latest price rise reflected increases in new and used car prices.

Chart III
QUITS AND LAYOFF RATES IN MANUFACTURING
Seasonally adjusted



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

LABOR MARKET DEVELOPMENTS

The nation's civilian unemployment rate soared to 6.5 percent in November, the highest level since October 1961. The 0.5 percentage point rise, which was widespread among major age and sex groupings, reflected the continued economic slump. Total civilian employment fell by 785,000 workers in November to the lowest level since December 1973. Over the first ten months of this year, employment had been advancing at a slow but irregular pace.

In the November payroll survey of nonfarm establishments, seasonally adjusted employment fell by 443,000 workers. Since this survey was taken early in the month, the drop did not reflect the strike by 120,000 members of the United Mine Workers union. The recent decline was pervasive, with employment down substantially in, among other sectors, machinery, electrical equipment, transportation equipment, furniture, and primary metals. Movements in the labor turnover rates underscore the deteriorating situation in the manufacturing sector (see Chart III). The layoff rate has jumped sharply from a rate of 1.3 per 100 employees in September to 1.9 percent in October, and the November and December figures, when available, will probably show that further increases occurred during those months because of shutdowns in the auto industry. Meanwhile, indicative of the reduced job opportunities, the number of people voluntarily leaving their present jobs has declined from an average rate of 2.6 workers per 100 employees in the first eight months of the year to 2.1 percent in September and October combined.

The employment picture was further clouded by the sharp drop in the average workweek. Production workers' average weekly hours dropped by 0.4 hour to 36.2 hours in November, the lowest level in the fourteen-year history of the survey. In manufacturing, the average workweek fell 0.6 hour in November to 39.5 hours. Overtime also dropped sharply, from 3.2 hours in the previous month to 2.7 hours in November.