The Business Situation

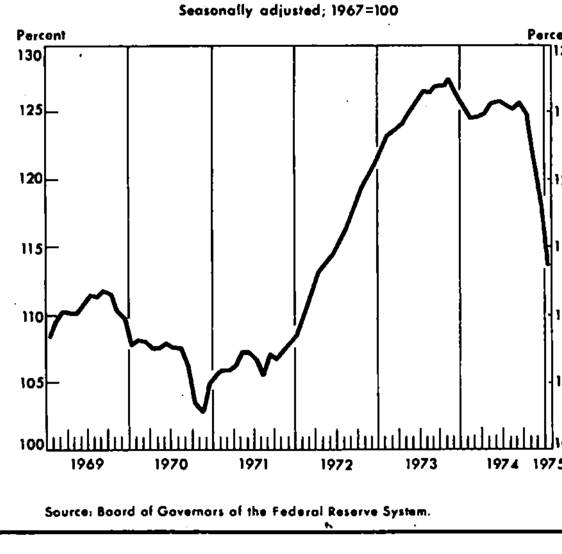
By nearly every measure, the economic contraction has deepened further in the new year. Industrial production fell 3.6 percent in January, and new orders for manufactured durable goods declined precipitously. Moreover, net new capital appropriations by the nation's 1,000 largest manufacturers were reported to have decreased in the fourth quarter of 1974 after several years of heady gains. There was a slim increase in personal income in January, but it was largely attributable to higher transfer payments, as income from salaries and wages declined $0.9 billion. Labor market conditions have continued to reflect the increasingly pervasive slack, with industrial work forces substantially reduced. Nevertheless, the economy's performance is not completely devoid of hopeful signs. Residential construction recovered a bit in January, as housing starts registered a slight gain, and retail sales posted a second consecutive monthly increase.

The reduced pace of economic activity in recent months has succeeded in dampening inflation, and the price outlook is more encouraging than it has been in some time.* Wholesale prices declined in February for the third time in as many months, led by sharp reductions in the prices of farm products and related items. While industrial wholesale prices increased, the rate of advance was considerably below the inordinately rapid rate observed throughout most of 1974. Furthermore, sluggish demand and weak materials prices have begun to exert a restraining impact on finished goods prices. At the retail level, the vigorous promotional efforts which sparked retail sales were accompanied by some price reductions, including the much-publicized price rebates on automobiles and some consumer appliances. Partly as a result, the consumer price index in January recorded its smallest monthly rise in nine months.

INDUSTRIAL PRODUCTION

On a seasonally adjusted basis, industrial production declined 3.6 percent in January (see Chart I). Combined with the revised 3.1 percent drop recorded in December, this constitutes the sharpest two-month slide in industrial output since the 1930's. The January decrease, the fourth in as many months, left the Federal Reserve industrial production index at 113.7 (1967=100). This is 9.5 percent below its level at the end of September 1974 and 10.8 percent beneath its cyclical peak of November 1973.

Chart I
INDUSTRIAL PRODUCTION
Seasonally adjusted; 1967=100



Source: Board of Governors of the Federal Reserve System.

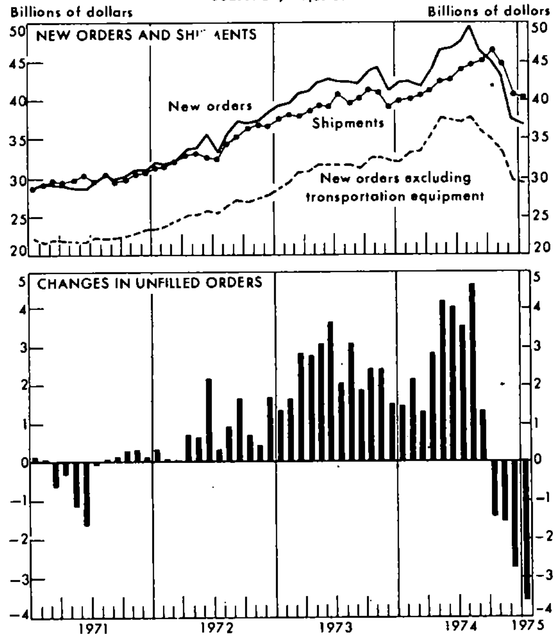
*Revised estimates indicate that the gross national product (GNP) increased $13.9 billion on a seasonally adjusted annual-rate basis in the fourth quarter of 1974. However, while the estimate of real GNP remained unchanged from the preliminary figure, a decline of 9.1 percent, the annual rate of change of the implicit price deflator for GNP was raised from 13.7 percent to 14.4 percent.

The January cutback in industrial output was widespread, with sharp reductions in business equipment, consumer goods, and industrial materials. The output of business equipment fell 4.6 percent in January, after having declined 3 percent in December. The production of consumer durable goods was reduced by 6.1 percent, in part because of the 9.5 percent cutback in automobile output. Automobile assemblies in January proceeded at an annual rate of 4.8 million units, down from 8.3 million units in October when the auto manufacturers first announced their intentions to reduce the scale of operations. In February, automobile production declined even further to an annual rate of 4.4 million units. Facing a large overhang of inventories and weakening prices, producers of industrial materials reduced their rate of output in January by 4.1 percent. This followed the 4.6 percent contraction in December and brought the decline in industrial materials production to 13.8 percent since September. In mild contrast to the other manufacturing sectors, output in the mining and utilities industries increased slightly in January. The gain was attributable, however, to the large increase in coal production during the period following the settlement of the miners' strike in December.

Chart II

ORDERS AND SHIPMENTS OF MANUFACTURED DURABLE GOODS

Seasonally adjusted



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

CAPITAL APPROPRIATIONS, DURABLES ORDERS, AND INVENTORIES

Appropriations for new plant and equipment by the nation's 1,000 largest manufacturing firms declined by 24 percent in the fourth quarter of 1974, according to a survey by The Conference Board, Inc. Total appropriations in the fourth quarter were $12.5 billion, compared with $16.4 billion in the third quarter. The petroleum industry accounted for the largest changes in appropriations in both the third and fourth quarters of 1974. In the third quarter, firms in the petroleum industry increased appropriations by 18 percent, compared with only a 4.6 percent increase in the other industries. In the fourth quarter, however, firms in the petroleum industry reduced their appropriations by 57 percent, while nonpetroleum industries cut back only 7.4 percent.

New orders for durable manufactured goods declined $1.1 billion in January, continuing the downtrend that began last August (see Chart II). Most of the January drop is attributable to a $1 billion fall in the orders for primary metals. However, there were also sizable declines in orders for transportation equipment and machinery. Looking at marketing categories, bookings for household durables inched up in January, but the important capital goods group registered a $650 million decrease. The backlog of unfilled orders for durable goods also fell in January, by $3.6 billion. The latest decline, the fourth in a row, was the largest percentage contraction in durable goods orders backlogs since 1960.

Durable goods industries accounted for the entire increase in total manufacturing inventories during January. Inventories in the durable goods sector increased by $1.2 billion, while they declined by $0.1 billion in the nondurable goods industries. The breakdown of the January inventory advance by stage of fabrication implies that much of the gain was unintentional. Of the total $1.1 billion increase, more than half—$620 million—was composed of finished goods, while materials and supplies on hand rose $260 million and work in progress increased by $200 million.

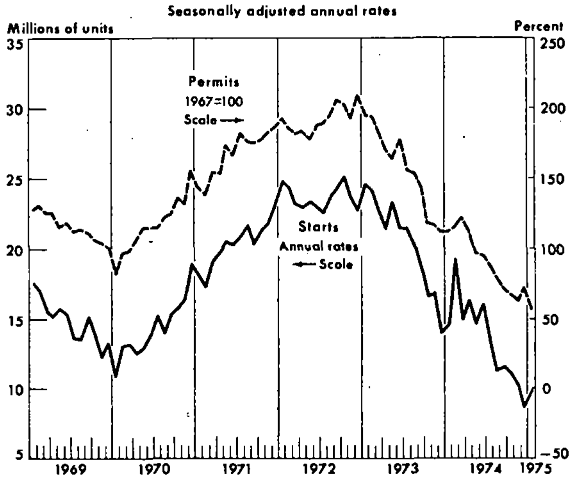
PERSONAL INCOME, RETAIL SALES, AND RESIDENTIAL CONSTRUCTION

Personal income rose $2.6 billion in January, down from the $7 billion monthly rise averaged during 1974. The January gain occurred despite a $0.9 billion decline in wage and salary income; increases in dividends and interest and in transfer payments offset the fall in wages and salaries. Reflecting the sharp cutbacks in employment and production, private industry payrolls decreased at a $1.8 billion annual rate in January. The reduction was concentrated in manufacturing, where payrolls have now fallen 6.4 percent since October and are only 0.6 percent above their level of January 1974. The weakness in manufacturing has been balanced somewhat by modest gains in wages and salaries in service industries and in government. In addition, transfer payments—social security, unemployment, and welfare and veterans' benefits—increased at a $2.7 billion rate in January, following a very large $6.3 billion increase in December. With the continued decline in farm prices, the income of farmers recorded its fourth consecutive monthly decrease in January. Over the year ended in January, farm income fell nearly 36 percent.

Spurred by unusually widespread clearance sales, retail sales increased 0.9 percent in January to a monthly total of $45.1 billion. This was the second successive increase in retail sales, following sizable declines in the three previous months. The dollar value of January's sales was 4.9 percent above that of a year earlier. However, since retail prices rose approximately 12 percent over this period, there has been a substantial reduction in the real volume of goods sold. Consumer spending on durable goods, which has been quite depressed in recent months by high interest rates and consumer pessimism, was 0.9 percent higher in January than in December. Most of the increase reflected the 2 percent increase in automobile sales that was motivated by the cash rebate programs initiated in the middle of the month. Sales of new domestic automobiles climbed to an annual rate of 6.6 million units in January and to 7.2 million units in February. Sales of nondurable goods were 1 percent higher in January than a month earlier and were 7.8 percent above their level of January 1974.

The residential construction industry showed tentative signs of recovery during January. Housing starts increased 13 percent to an annual rate of 987,000 units, up from December's 875,000 units (see Chart III). The prospects for further recovery remain clouded, however. The issuance of new building permits, which is sometimes an indicator of building activity in the following month or two, declined in January to the lowest point on record for the series, which dates to 1959. On the other hand, thrift institutions have realized substantial net deposit inflows during recent months. These inflows, combined with declines in short-term interest rates, should increase the supply of mortgage funds and eventually lead to lower financing costs. Another positive factor is the recent decline in the vacancy rate in multiple dwellings, which fell 0.2 percentage point during the fourth quarter of 1974 to 6 percent. The rental vacancy rate normally moves quite slowly, and a decline of this size indicates a firmer tone in the rental market which could stimulate new construction in the coming months.

Chart III
PRIVATE RESIDENTAL CONSTRUCTION
Seasonally adjusted annual rates



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

PRICE DEVELOPMENTS

In recent months, prices at the wholesale and retail levels provided further evidence that the rate of inflation is abating. Wholesale prices in February declined at a 9.2 percent annual rate, the third consecutive monthly decrease. While consumer prices in January increased at a 7.7 percent annual rate, this was the slowest advance since last April.

Contributing to the February decline in wholesale prices was the sharp 41.1 percent annual-rate drop in prices of farm products and processed foods and feeds. This weakness in farm product prices, following substantial declines in December and January, has led agricultural experts to speculate that supply conditions in these markets may have permanently improved and that food prices in the near future may be weaker than they were previously expected to be. The prices of industrial commodities at the wholesale level increased at a 6.5 percent annual rate in February. These prices over the past three months have risen at a 4.3 percent annual rate, which stands in sharp contrast to their performance during the preceding twelve months when they rose 27.4 percent. The wholesale prices of basic raw materials fell at a 1.1 percent rate in February which, following their 19.4 percent rate of decline in January, suggests that final goods prices may soften in the months ahead as the recent decreases in materials prices work their way forward to advanced stages of production.

January marked the second consecutive month that the rate of inflation at the consumer level has slowed. Retail food prices increased at a 9.9 percent rate, slightly more rapid than December's advance. However, the acceleration is attributable to hikes in the prices of restaurant meals; grocery prices actually rose somewhat more slowly than they had in December. The prices of nonfood consumer items advanced at a 6.7 percent rate, as increases in the prices of shoes, gasoline, and household durables more than offset the decline in new car prices. In contrast, over the year ended November 1974, the prices of nonfood consumer items had risen 12.3 percent. The prices of services increased at a 9.6 percent rate in January, with household utility costs registering a substantial increase.

LABOR MARKET DEVELOPMENTS

Labor market conditions deteriorated somewhat further in February, although the unemployment rate remained unchanged at 8.2 percent of the civilian labor force. Nonagricultural employment declined by over 450,000 persons, but this was more than matched by a fall in the labor force. The February decline in employment was the fifth in as many months, bringing the total decrease over the period since September 1974 to more than 2.2 million workers. Reflecting the reductions in industrial production, most of the drop in employment has occurred among adult males in manufacturing, while employment in the nonmanufacturing sector has fallen relatively little since September. The sharp decline in the labor force in February reversed the growth of recent months. Indeed, over the five months ended in February, the labor force decreased by nearly 340,000 workers. Taking a somewhat longer perspective, over the year ended in February the labor force climbed by 955,000, or 1.1 percent.

January's labor turnover rates also reveal the degree to which industry's demand for labor has eroded in recent months. The layoff rate jumped sharply to 3.5 percent, up from 2.6 percent in December. This increase brought the layoff rate in January to nearly three times what it was in September, when industrial production began to decline in earnest. Meanwhile, the scarcity of job openings caused the number of workers voluntarily leaving their jobs to decline to 1.4 percent. In September the quit rate was 2.1 percent, and in January 1974 it was 2.6 percent.