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Inflation and the Economic Outlook*

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This morning I would like to spend some time with you reviewing the current economic situation and the outlook for the coming year. As you know, it is a subject that has been receiving considerable attention these days. A good way to start is to look at some of the significant developments of the past year and their implications for the new year.

The year 1973 was memorable for the economy, for many reasons. It started out with the termination of the Phase Two controls in January, quickly followed by an international currency crisis and the second devaluation of the dollar in February. And the year ended in December with the economy—and the world in general—still dazed by the effects of the oil embargo, but finally attempting to come to grips with the underlying problem of energy shortages. It was also a year that saw the Dow Jones average slide by over 150 points between January and December.

Looking back at the year as a whole, however, perhaps its most important characteristic—and one whose importance was not as well recognized as it might have been—is that 1973 was a boom year, a year of exploding prices, a year of burgeoning inflation, and a year marked by enormous pressures on productive facilities.

Real output rose extraordinarily over much of 1972 and through the first quarter of 1973, measured in terms of both real gross national product (GNP) and industrial production. As a result, the economy suffered severe capacity constraints beginning early last year—a development that many economists, statisticians, and policy makers were slow to recognize. The conventional view in late 1972 was that, because the overall unemployment rate remained significantly over 4 percent, output limits were still quite distant. In retrospect, this was a misjudgment, and in some respects it may have encouraged overly expansive monetary and fiscal policies in 1972. By early 1973, the serious pressures we still see today had already been developing.

These pressures show clearly in the economic barometers. Capacity utilization of major materials-producing industries was at record levels. This factor—the nearly complete utilization of capacity—and not tightness in the labor markets—was the most conspicuous bottleneck in the economy during the year.

Labor markets were, of course, fairly tight during most of 1973, with the unemployment rate dropping to 4.6 percent in October. That figure may not seem to indicate substantial tightness compared with historical figures—such as the low of about 3.5 percent in the late 1960's. However, the overall rate doesn't provide the best historical measure because of the rising proportion of young people and women in the labor force, two groups with above-average unemployment rates. In any case, while the labor markets were relatively tight last year, they have been as tight or tighter before, and they do not seem to have been the primary cause of supply constraints during the year.

In retrospect, it seems clear that it was primarily the strain on capacity worldwide, compounded by a number of other factors (such as grain and protein shortfalls), which resulted in a rather distressing price performance for the year—and despite the continued existence of a price control program. The situation was aggravated by additional pressures that resulted from the abrupt spurting of prices as soon as Phase Two was terminated, the devaluation of the dollar, the reemergence of excess demand, and the further rounds of price increases in anticipation of the reimposition of stricter controls.

As you will recall, the price explosion that took place

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at the beginning of Phase Three subsequently led to the two-month price freeze starting June 13, and then the establishment of the Phase Four controls in mid-August. Phase Four is still with us, although controls have been lifted from many industries. It may be too soon to pass final judgment on Phase Four, but no one can be very enthusiastic about it. Since June, consumer price increases have actually accelerated, even compared with Phase Three. In any case, the Administration is willing to allow statutory authority for controls to lapse at the end of April, except for fuel and health care.

Consumer prices haven't yet fully reflected the advances in wholesale industrial prices. We don't know what the ultimate effects will be, but in any case we can't be too optimistic about the future.

Looking back with the benefit of hindsight at the overall control program, while Phase Two looked successful, it is now clear to most observers that subsequent developments had distorting, disincentive effects in many cases, encouraging exports and discouraging production for the domestic market precisely in those areas where shortages have been worst. Perhaps just as important is the fact that this performance has generated a widespread disillusionment with controls on the part of both business and labor.

Some cautious optimism on the price outlook for 1974 developed last fall as food prices dropped well off their August peaks. It did not seem likely that the 1973 price bulge would be repeated, since world demand pressures on commodity prices generally appeared to be abating. In addition, the worst of the post-freeze bunching of industrial price increases seemed likely to be completed early in 1974. But the energy shortage has darkened that prospect, and now fuel prices are vying with food prices as the chief villain in the inflation drama.

Nobody seems to be too sanguine about the prospects for prices in 1974. The range of recently published forecasts for 1974 prices is rather wide, reflecting deep uncertainties, but they all indicate continuing high levels of inflation. The Council of Economic Advisers forecast a 7 percent increase in the GNP price deflator in its annual report. Even the low end of the range of recent forecasts is a relatively high figure of about 5 percent, and even that is wishful thinking—although it's not impossible that improvement by the second half might materialize.

Turning to forecasts of GNP, current statistics show a definite slowing in the economy that, so far, seems consistent with the consensus forecast of a slowdown in real GNP. However, it is difficult to be sure how far the trend will carry.

Growth in industrial production and real output slowed sharply in the fourth quarter. Industrial production actually declined in December, January, and February largely as a result of energy cutbacks and slowing production in the auto industry, which has its special, and partly energy-related, problems.

The unemployment figures have also reflected some slowing in the economy, in good part because of the energy situation. The rate rose from a low of 4.6 percent in October to 5.2 percent in January and then remained at that level in February. At this point, it would appear that, with the present labor market structure and composition, unemployment rates of under 5 percent can't be sustained for very long without accelerating inflation rates. Nevertheless, unemployment rates could well rise this year—at least for a time—to undesirable levels.

Turning to the outlook for demand, we see areas of both weakness and strength. Housing has been for some time the primary example of weakness. Housing starts declined over much of 1973 to levels that were low in relation to long-term trends. With an improved flow of funds into thrift institutions, however, most analysts have been assuming that an upturn would develop by mid-year. Indeed, starts rose in both January and February, but it would probably be premature to conclude that a sustained upturn has already begun.

The second most obvious area of demand weakness has been cars. Of course, an easing of the gas shortage and the completion of plans to shift output to smaller cars should begin to provide a lift. However, it should also be noted that, after adjusting for price increases, retail sales excluding autos have been essentially flat for many months.

On the optimistic side, one area of seemingly clear prospective strength is business capital spending. Various government and private surveys suggest a 12 to 18 percent rise in business capital spending this year, which isn't surprising given the capacity problems in many industries.

Another plus in the outlook is the low level of inventories relative to sales—with the conspicuous exception of standard-size cars. Indeed, shortages are probably holding stocks below desired levels in some fields. Thus, on balance, there are no signs of impending excess-inventory problems that have been associated with most postwar recessions.

As far as the Federal budget is concerned, the projected fiscal 1975 deficit is scheduled to rise moderately, mainly because a slower economy should cut tax receipts. However, it seems more pertinent that there is likely to be another large rise in outlays. On balance, we would characterize the 1975 budget as being like the current fiscal 1974 budget—moderately stimulative.

As for monetary policy, in retrospect it is now generally

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agreed that the growth of monetary aggregates in 1972 was somewhat excessive. The Federal Open Market Committee wasn't willing at that time to see money market conditions tighten up to the degree and with the speed necessary to ensure a slower growth rate. In 1973, however, a number of steps were taken to lower the growth of these aggregates to a more moderate rate. For example, marginal reserve requirements on large certificates of deposit (CDs) and related bank sources of funds were raised. The discount rate was advanced in six steps to the current all-time peak of 7.5 percent. Most important, open market operations were aimed at bringing the monetary aggregates under tighter control.

While everyone would agree that we went through a period of relatively tight money in 1973, there are various ways of assessing just how tight it was. M_1 (checking account balances and currency outside banks) averaged a moderate and appropriate 5.7 percent over 1973 as a whole. Within the year, however, the aggregates showed, as always, wide short-run fluctuations.

This may be a good point to note that the Federal Reserve's ability to control the growth rates of the money supply and bank credit over short periods is very limited. Moreover, short-run deviations—say, up to six months—from longer term objectives are probably not damaging to the economy, at least if they are subsequently offset. I'm afraid that there is a widespread tendency to try to over-interpret these short-run movements.

As for bank credit growth, it was quite rapid through much of 1973 partly because of the assignment of the Committee on Interest and Dividends, under the control program, to hold bank loan rates from rising as fast or as far as they might otherwise have. As a result, banks were an unusually cheap source of funds until open market rates, such as the commercial paper rate, began falling in September. Thus, more lending moved through the banking system earlier in the year than would have been normal for a tight-money period. Banks financed the loan expansion by issuing CDs, a technique that was enhanced by the absence of Regulation Q ceiling restraints.

Slowing the money supply growth rate during 1973 in the face of a strongly advancing economy involved some very sharp short-term rate advances to historical peaks by late summer. Indeed, the behavior of short rates is the only measure by which money could be characterized as being exceptionally tight in 1973. The slowing in the growth of the monetary aggregates was less pronounced than in several other periods of restraint. Moreover, there was very little indication of credit rationing and credit shortages this time—with the exception of housing for a time after June. Although monetary policy in particular, and financial conditions in general, helped encourage some needed slowing in the economy, they at no time produced conditions of extreme restraint.

As for GNP forecasts for 1974, you will recall that last fall a consensus was emerging that the economy's growth would be noticeably less rapid in 1974 but that we would avoid a recession. An October survey of private forecasts showed a median year-to-year rise in real GNP of about 2.5 percent. This would have been significantly below the "normal" growth trend—usually reckoned at 4 to 4.5 percent—and would have been compatible with very small or near zero growth in some individual quarters in 1974.

But then came the Arab oil embargo, and the fall forecasts—which looked quite reasonable at the time—had to be redone. It appears that, on average, forecasters cut their estimates of real GNP growth this year by about 1 percentage point, a significant but still moderate reduction. One survey, taken in December, suggests that most economists were then estimating real growth for 1974 at between zero and 2.5 percent, with many estimates clustering around a median of 1.5 percent. Most of these forecasts apparently assumed that the oil embargo would be over by midyear. Presumably if it had been known that the embargo would be substantially ended by late in the first quarter, the forecasts would have averaged somewhat higher.

If growth turns out reasonably close to the consensus view, one or possibly two quarters of outright declines in output would be a reasonable inference. Also implicit in such a forecast is some rise in the unemployment rate, perhaps to the 5.5 to 6 percent range by the end of the year.

The economic outlook, which is always uncertain, was of course open to an especially high degree of uncertainty this year until the recent announcement that most of the participating Arab countries would remove their embargo on oil shipments to this country. Questions of the impact and duration of the embargo had represented a considerable cloud of uncertainty for businessmen and policy makers. The ending of the boycott should represent a clear gain for the economy.

To sum up, the current picture of the economy is a mixture of clear pluses, clear minuses, and clear question marks: There are still many signs of shortages and demand pressures, together with some indications of reduced demand in other areas. On balance, I would think that we are seeing about what might be expected in terms of the standard forecast—in other words, a relatively brief, relatively mild, and heavily shortage-induced downturn. While this produces problems, it should at least create some

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breathing space in the economy, something which is absolutely necessary if our really dangerous rate of inflation is to be tamed.

One might question the role of monetary policy in our present situation, where we have rampant inflation coupled with a slowing in the economy that has been, and continues to be, aggravated by various sorts of shortages. In view of what I have said already, it will not surprise you that I believe our number one problem is bringing a highly dangerous inflation under control. It seems quite clear that inflation over the past year or so has been importantly influenced by excess demand conditions and that monetary policy can make an important contribution to relieving this situation. Failure to slow inflation now runs the risk of its further acceleration, accompanied by increased social tensions and, ultimately, serious economic readjustments. As I have already indicated, the current economic weakness appears to me to be localized and relatively minor in proportion. In these circumstances, additional stimulus from monetary policy at this point would seem to pose significant risks. Of course, we must also continue to keep a close eye out for any signs of a cumulating weakness in demand, despite the absence of any real signs of such a development at present.

Looking for a moment at the international side, 1974 presents a wide range of possibilities. There was a substantial improvement in the United States trade position over the course of 1973, with a year-to-year turnaround of about $7.5 billion in our net merchandise exports. Our agricultural exports moved up very sharply. Moreover, nonagricultural exports, including a very wide range of goods, also showed substantial gains. It seems clear that in many areas our goods are once again competitive. Indeed, exports certainly would have been higher if we had had the capacity necessary to produce more.

On the import side, the dollar cost rose significantly further but excluding fuels the real volume of imports, in constant dollars, on balance actually declined between the first and fourth quarters of the year. This decline reflected the significant change in costs resulting from the dollar devaluations, as well as the fact that foreign productive capacity abroad was stretched tight by the worldwide boom conditions.

There are a couple of things that emerge from the 1973 trade picture that may be useful in helping us look ahead. On agricultural goods, the volume of exports held relatively steady following an initial jump in the first quarter, while the rest of the gain resulted from price increases. The general expectation seems to be that our agricultural exports will remain strong.

With respect to other goods, it is clear that we are again in a relatively strong competitive position. As the economy slows and capacity limitations are less of a constraint, we should be able to continue to increase our share of nonagricultural exports. The major uncertainty in the outlook for this area is the level of economic activity abroad, particularly in relation to the impact of oil-related problems on industry, and the efforts that foreign countries may make to finance increased oil bills by expanding exports and reducing other types of imports.

Given the slowing in the United States economy, there is little reason to expect an acceleration of our imports apart from fuels. Imports of smaller foreign cars may rise, but we shouldn't expect that to be a significant problem in the overall picture. Fuels, of course, are another story. All that can be said with any certainty is that the nation's oil bill will grow substantially. It is easy to project an increase of as much as $14 billion in 1974, based on 1973 import volumes and January 1, 1974 prices. But both of these assumptions are clearly open to question. In view of the magnitude of the uncertainties, it is very difficult to guess how the overall balance of trade will come out at the end of 1974.

Looking for a moment at the question of capital flows, it seems clear that the reopening of the United States market for long-term borrowing will lead to a considerable outflow on that account, with recent estimates running from $1.5 billion to $2 billion all the way to $4 billion. However, we could well see a further rise in long-term capital inflows similar to the kind that began emerging in 1973. Moreover, it is likely that some portion of the excess receipts of the oil producers will turn up in the United States directly or indirectly in medium- to long-term forms.

Short-term capital flows are obviously going to be subject to a variety of conflicting forces. There may be some shifting of short-term lending to foreigners from overseas branches to head offices of United States banks as the result of the removal of restraints on bank lending to foreign residents. However, the short-term flows will probably depend greatly on relative interest rates in the United States and in Europe. Relative rates will be affected by how other countries finance their oil deficits and where the oil-producing countries place their receipts. It is impossible to say which way the net flow will go at this point, but it seems likely that with the removal of capital controls here and abroad short-term rates will tend to converge more than in recent years.

Finally, we should spend a few moments on the exchange rate situation. As you are aware, the efforts of the past two years to achieve a comprehensive and formal monetary reform have not been especially fruitful, particularly in the

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light of recent developments. It has been clear for quite a while that there has been only limited agreement achieved, and even then only in broad terms, with considerable disagreement over crucial operational details. Meanwhile, during the past year we have had a regime of "managed" floating—"managed" primarily by means of central bank intervention. If we add up official intervention in the exchange markets since floats began in March 1973, the total is over $35 billion, a figure probably exceeding the intervention over any similar period under fixed rates. Despite this massive volume of intervention, we have continued to have very substantial and often erratic movements in exchange rates. Considering the events of the past year, both economic and noneconomic, it is doubtful that we could have done better under any other system. However, I don't think that our experience makes a very persuasive case for floating rates. Gabriel Hauge of Manufacturers Hanover Trust Company in New York City put it very well recently when he said:

> Although most economists still appear to favor a floating exchange rate system, careful monitoring of the current experiment in floating has not been reassuring, at least to me. At times last year, the major currencies fluctuated sharply against each other, leading to the kind of highly unstable situation that floating was supposed to obviate. The system made it possible for the dollar to be driven down to an unreasonable level against many other currencies, so that the United States public is now paying the price in terms of added inflation for the instability of the floating rate system. As I contemplate the recent experience with the theoretically appealing case for floating, I cannot but recall Charles Kettering's warning, "Beware of logic; it is an organized way of going wrong with confidence".

In the end it seems rather clear that a major factor carrying the monetary system through the shocks of the past six months has been the general strength of the dollar. Regardless of how many people want a substitute, and how much they want to reduce the system's dependence on the dollar, that dependence inevitably will continue for some time. Consequently, full restoration of confidence in the dollar still remains the key to reasonable stability in the monetary system. As Chairman Burns stated recently to the Congress:

> Confidence in the dollar is essential both to a healthy domestic economy and to a successful evolution of the international monetary system. Looking to the future, we must strive to conduct all our economic policies—domestic as well as international—in such a manner that they will maintain, and indeed strengthen, that confidence.

Confidence is indeed essential. And confidence cannot be won unless and until it can be clearly demonstrated that the forces of inflation—which have been with us for so long—can and will be brought under control. Hopefully, the coming year will see a substantial movement toward that goal.

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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.

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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.

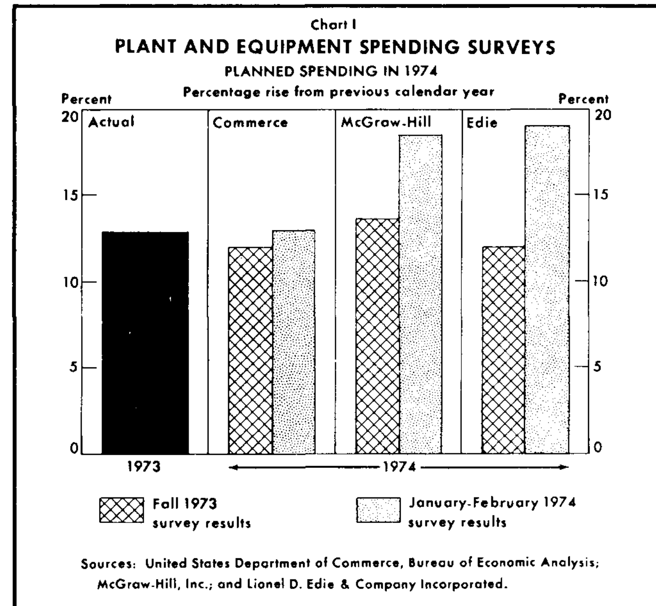
For all businesses, the ratio of inventories to sales dropped from 1.46 in December to 1.43 in January, thus putting the ratio only slightly above the post-Korean war low of last November. The latest decline was in part the result of a strong rebound in business sales in January following the decline 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



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 concen-

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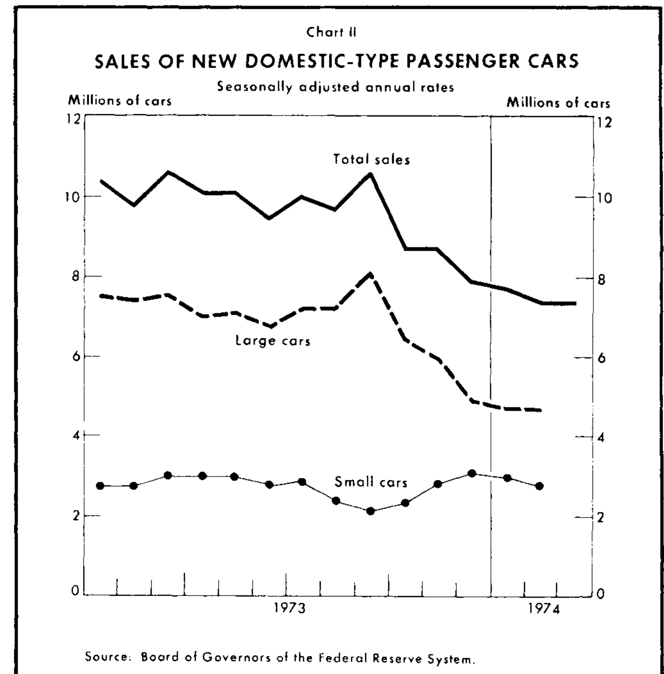
trated in private wage and salary disbursements, which rose $3.2 billion largely as a result of increases in payroll employment, the average workweek, and hourly earnings. In comparison, wages and salaries had fallen $1.7 billion the month before. However, wage and salary payments in the manufacturing 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 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. Conse-

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quently, 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

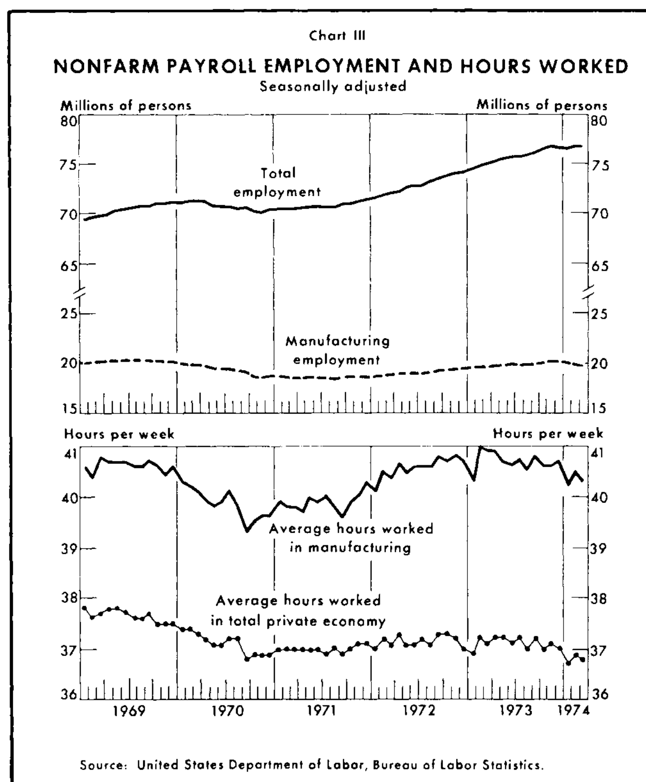
The latest data indicate that prices continue to rise at extraordinarily rapid rates. Although wholesale agricultural prices registered a fairly broad-based decline during March, some observers fear this development could be reversed in coming months. Moreover, the extreme volatility exhibited during 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 leu 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-



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.

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The Money and Bond Markets in March

Interest rates moved substantially higher during March. Yields rose particularly sharply from midmonth on, following more moderate increases early in the period. In the money market, the rate on four- to six-month commercial paper rose about ⅜ percentage point during the first fourteen days of the month and then climbed a full percentage point over the remainder of the period. The average effective rate on Federal funds rose to 9.35 percent from its average of 8.97 percent in February, while the rate on bankers' acceptances increased by more than a percentage point. Most major commercial banks also raised their prime lending rates on loans to large business borrowers ½ percentage point to 9¼ percent.

Yields on Government securities rose over much of March. Expectations of a near-term easing of monetary policy vanished, as the economy exhibited greater than expected strength and inflation continued at a rapid pace. The firmness of the money market served to confirm the System's restrictive stance. The Treasury financing late in the month contributed to the rise in rates, since investor demand had been quite modest and dealers were concerned about a buildup in inventories. Over the month, the rates on three- and six-month Treasury bills each increased by some 85 basis points, while the yield on three- to five-year coupon securities registered about an 80 basis point rise. There was a somewhat smaller increase in the yield on long-term Government securities. Under the pressure of a sizable calendar of new issues and heavy inventories from earlier months, rates on corporate and municipal bonds also increased considerably in March. Over the month, the Federal Reserve Board's index of yields on newly issued Aaa-rated utility bonds increased 34 basis points to 8.64 percent, its highest level since November 1970. At the same time, The Bond Buyer index of municipal bond yields rose 31 basis points to its highest level since last August.

Preliminary data indicate that the seasonally adjusted narrow money stock (M_1)—private demand deposits adjusted plus currency outside commercial banks—grew at a rapid rate in the four statement weeks ended March 27 following a sizable increase in February. However, the growth of time and savings deposits at commercial banks, other than large negotiable certificates of deposit (CDs), slowed over the four statement weeks in March, and the broad money stock (M_2)—M_1 plus consumer-type time and savings deposits at commercial banks—rose somewhat less rapidly than M_1. Following a very small increase in February, the adjusted bank credit proxy, which includes deposits of member banks plus certain nondeposit liabilities, expanded more strongly in the four-week period ended March 27 as all its components increased.

THE MONEY MARKET, BANK RESERVES, AND THE MONETARY AGGREGATES

Interest rates on most money market instruments rose sharply in March (see Chart I), after declining on balance during the three preceding months. For the month as a whole, the effective rate on Federal funds averaged 9.35 percent, 38 basis points above its February average. Commercial paper rates registered sizable increases during March as well. These increases ranged from ¾ percentage point on some maturities of directly placed paper to 1⅜ percentage points on some dealer-placed paper. The bid rate on bankers' acceptances closed the month at 9.75 percent, 1½ percentage points higher than at the start of the period. In line with the rise in other money market rates, most major commercial banks raised their prime lending rates to large business borrowers ½ percentage point to 9¼ percent by the end of the month. Early in April, most large banks raised their rates in two steps to 9¾ percent. For the second consecutive month, member banks also increased their reliance on the discount window. The average level of borrowings rose $83 million in March to $1,278 million (see Table I).

The secondary market offering rate on large negotiable CDs moved higher in March, as commercial banks attempted to counter the heavy maturities that usually occur around the corporate tax and dividend date. The rate on CDs of three months' maturity closed the month

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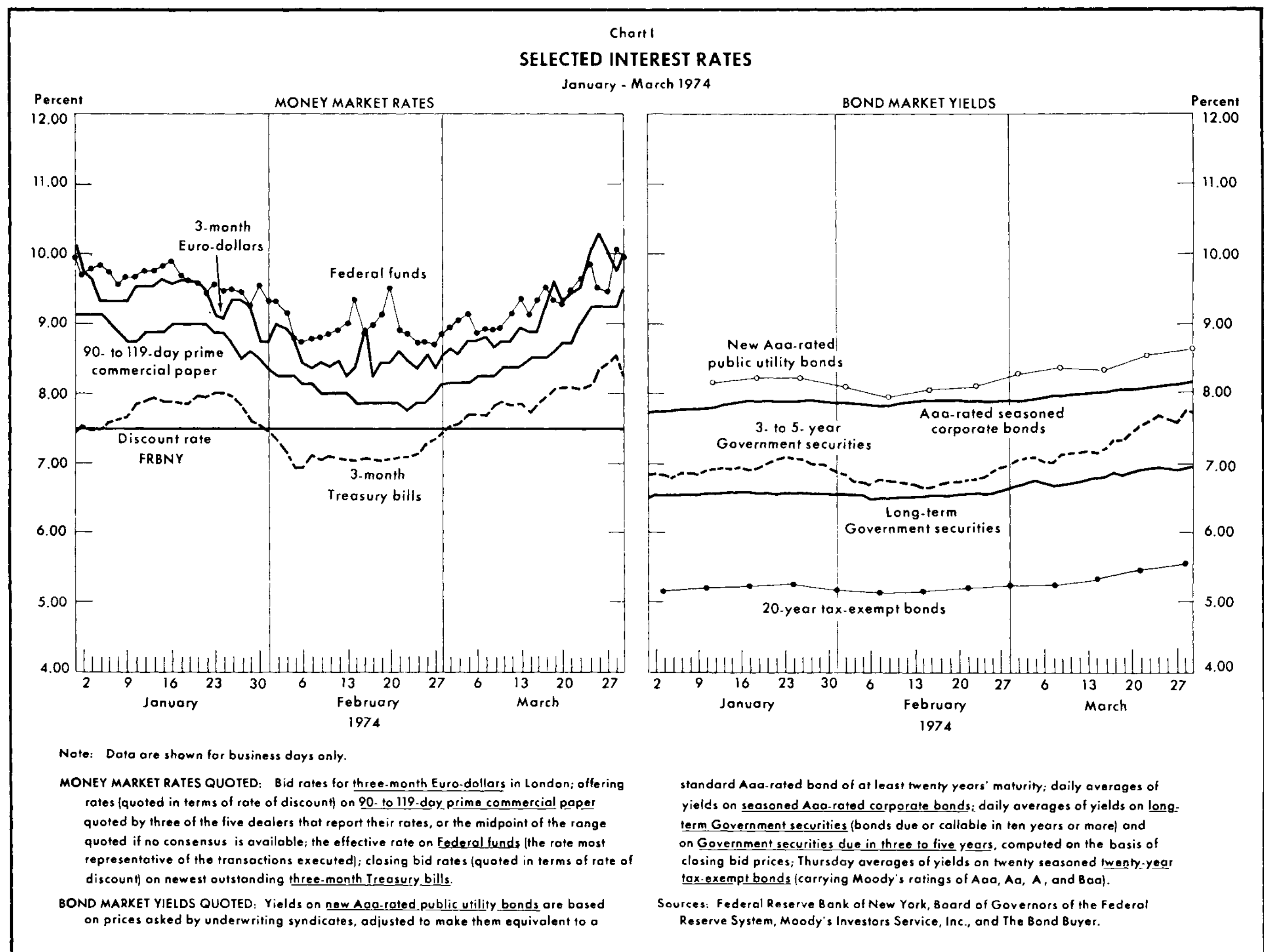

Note: Data are shown for business days only.

MONEY MARKET RATES QUOTED: Bid rates for three-month Euro-dollars in London; offering rates (quoted in terms of rate of discount) on 90- to 119-day prime commercial paper quoted by three of the five dealers that report their rates, or the midpoint of the range quoted if no consensus is available; the effective rate on Federal funds (the rate most representative of the transactions executed); closing bid rates (quoted in terms of rate of discount) on newest outstanding three-month Treasury bills.

BOND MARKET YIELDS QUOTED: Yields on new Aaa-rated public utility bonds are based on prices asked by underwriting syndicates, adjusted to make them equivalent to a standard Aaa-rated bond of at least twenty years' maturity; daily averages of yields on seasoned Aaa-rated corporate bonds; daily averages of yields on long-term Government securities (bonds due or callable in ten years or more) and on Government securities due in three to five years, computed on the basis of closing bid prices; Thursday averages of yields on twenty seasoned twenty-year tax-exempt bonds (carrying Moody's ratings of Aaa, Aa, A, and Baa).

Sources: Federal Reserve Bank of New York, Board of Governors of the Federal Reserve System, Moody's Investors Service, Inc., and The Bond Buyer.

at 9.60 percent, up 1⅜ percentage points over the period. Banks were apparently able to replace the maturing CDs, since the total of CDs outstanding increased slightly during March. However, the rate of growth was modest when compared with the pace of the two preceding months.

According to preliminary data, seasonally adjusted daily average M_1 grew substantially over the four statement weeks ended March 27 relative to its average of the preceding four-week period. From its average of the four weeks ended thirteen weeks earlier to its average of the four weeks ended March 27, M_1 grew at a 6.5 percent annual rate; this is essentially the same as its increase from the average of the four weeks ended a year earlier (see Chart II). The growth of commercial bank time and savings deposits other than large CDs slowed over the four-week period ended March 27, and the advance of M_2 was less rapid than that of M_1. Because of the faster rise in such deposits during previous months, however, M_2 grew more rapidly than M_1 from its four-week average of thirteen and fifty-two weeks earlier.

Growth of the adjusted bank credit proxy accelerated in the four weeks ended March 27 relative to its slow February pace. An expansion in all major components of the proxy accounted for the acceleration. From the average of the four weeks ended a year earlier to the four-week period ended in March, the proxy grew nearly 9 percent.

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THE GOVERNMENT SECURITIES MARKET

Yields on Treasury issues rose substantially during March, largely in response to mounting concern over the near-term outlook for monetary policy. Earlier hopes for some further easing of monetary restraint were based on the assumption that the Federal Reserve would act to bolster the economy when the widely forecast slowdown in activity occurred. As matters developed, however, most of the economic indicators reported in March pointed to underlying strength rather than weakness, and the lifting of the Arab oil embargo lent support to this conclusion. Moreover, given the unusually large increase in the money supply in recent weeks and the continuing rapid rate of inflation, participants reasoned that some tightening of System policy was likely in an attempt to check these developments. The higher rate levels at which Federal funds traded during March seemed to many observers to confirm that additional restraint was being applied.

At the beginning of March, yields on Treasury coupon securities continued the advance which had been under way since the middle of the previous month. Statistics available early in the period showing a further rapid rise in the money supply served to depress market sentiment. However, these higher yields attracted some investor interest, and this subsequently imparted a degree of stability to the market. At the end of the first week, the market reacted negatively to reports indicating a stronger than expected labor market and substantial business loan demand. These data were seen as reducing the need for an easing of monetary policy, and yields resumed their advance. At about midmonth, yields rose sharply following news of another large increase in the money supply and of continued strong business loan demand. The weakening persisted for several days, fostered by sluggish investor demand and firm conditions in the money market. Another factor which added to the upward pressure on yields was the expectation and, later, the fact that the Treasury would raise new funds in part by selling a coupon issue.

After the close of business on March 20, the Treasury announced a $4 billion new cash borrowing. This financing consisted of an additional $2.5 billion of 84-day tax anticipation bills and $1.5 billion of two-year 8 percent notes. The borrowing was somewhat larger than many had anticipated, and a number of participants pressed outstanding coupon issues on the market following the announcement to position themselves for the auction. Consequently, yields increased further. At the auction of the notes on March 28, the average issuing rate was set at 8.08 percent. The issue proved attractive to small in-

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, MARCH 1974

In millions of dollars; (+) denotes increase and (—) decrease in excess reserves

Factors	Changes in daily averages—week ended				Net changes
	March 6	March 13	March 20	March 27	
"Market" factors					
Member bank required reserves	+ 130	— 117	— 494	+ 526	+ 45
Operating transactions (subtotal)	+ 429	+ 35	— 766	— 860	—1,162
Federal Reserve float	— 418	+ 92	— 211	— 150	— 687
Treasury operations*	+ 736	+ 160	+ 469	— 987	+ 378
Gold and foreign account	— 68	+ 51	— 23	— 7	— 47
Currency outside banks	+ 94	— 332	— 832	+ 327	— 743
Other Federal Reserve liabilities and capital	+ 85	+ 64	— 169	— 43	— 63
Total "market" factors	+ 559	— 82	—1,260	— 334	—1,117
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	— 377	— 21	+ 677	+ 136	+ 415
Outright holdings:					
Treasury securities	— 367	— 415	+ 561	— 147	— 368
Bankers' acceptances	— 3	— 2	+ 3	+ 4	+ 2
Federal agency obligations	— 7	— 21	— 25	+ 146	+ 93
Repurchase agreements:					
Treasury securities	—	+ 378	+ 114	+ 96	+ 588
Bankers' acceptances	—	+ 17	+ 28	+ 25	+ 70
Federal agency obligations	—	+ 22	— 4	+ 12	+ 30
Member bank borrowings	— 320	+ 53	+ 500	+ 228	+ 461
Seasonal borrowings†	+ 3	—	+ 15	+ 10	+ 28
Other Federal Reserve assets‡	+ 50	+ 60	+ 23	+ 48	+ 181
Total	— 647	+ 92	+1,200	+ 413	+1,058
Excess reserves‡	— 88	+ 10	— 60	+ 79	— 59
	Daily average levels				**Monthly averages§**
Member bank:					
Total reserves, including vault cash‡	34,633	34,760	35,194	34,747	34,834
Required reserves	34,515	34,632	35,126	34,600	34,718
Excess reserves	118	128	68	147	115
Total borrowings	931	984	1,484	1,712	1,278
Seasonal borrowings†	19	19	34	44	29
Nonborrowed reserves	33,702	33,776	33,710	33,035	33,556
Net carry-over, excess or deficit (—)‖	132	66	75	36	77

Note: Because of rounding, figures do not necessarily add to totals.
* Includes changes in Treasury currency and cash.
† Included in total member bank borrowings.
‡ Includes assets denominated in foreign currencies.
§ Average for four weeks ended March 27, 1974.
‖ Not reflected in data above.

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vestors, but reportedly few institutions were among the buyers. Over the month as a whole, yields on intermediate issues rose by about 65 basis points on average, while long-term bond yields advanced by some 35 basis points.

Rates on Treasury bills also experienced sizable increases in March as a result of many of the same factors which affected yields on Treasury coupon issues. Bill rates rose at the start of the month in response to firmer money market conditions and indications of continued rapid growth in the money stock. The average issuing rates for the new three- and six-month bills set at the first weekly auction of the month were some 49 basis points above those of a week earlier. Bill rates moved irregularly lower the next several days and then resumed their rise, initially in response to the report of the stability of the unemployment rate in February. Then, primarily in reaction to an exceptionally large one-week rise in M_1, bill rates moved sharply higher at midmonth and continued their ascent over succeeding days, as participants prepared for the Treasury's expected new cash borrowing. Similarly, rates at the regular weekly auctions advanced as the month progressed (see Table II). On March 26, the Treasury auctioned the $2.5 billion of 84-day tax anticipation bills. Bidding in the auction was good, at least partly reflecting the fact that commercial banks were able to pay for the bills by crediting Treasury Tax and Loan Accounts. The bills were issued at an average rate of 8.31 percent. Over the month as a whole, bill rates generally increased about 87 to 127 basis points.

Yields on Federal agency and Federally guaranteed securities also increased during March. On March 12 the Washington, D.C., Metropolitan Area Transit Authority issued $225 million of Federally guaranteed Aaa-rated bonds priced to yield 8.17 percent in forty years. The bonds encountered buyer resistance and, three days later when the bonds were released to trade freely, the yield increased by about 13 basis points. Later in the month, two farm credit agencies marketed new issues. Specifically, the Federal Intermediate Credit Banks sold $608 million of nine-month 8.15 percent bonds and the Banks for Cooperatives offered $251.2 million of six-month 8.20 percent bonds. These issues were initially well received, but they subsequently traded at slight discounts.

THE OTHER SECURITIES MARKETS

Interest rates on both corporate and municipal bonds climbed substantially during March in the face of a sizable calendar of new issues and a heavy backlog of unsold bonds. Measured by the Federal Reserve Board's series on new and recently issued Aaa-rated utility bonds, yields on corporate bonds rose in March to their highest levels since late 1970. The March schedule of tax-exempt offerings, although not so heavy as the corporate calendar, coupled with the large inventories left from February resulted in upward pressure on rates in this market as well. Consequently, The Bond Buyer index of twenty municipal bond yields rose to 5.57 percent on March 28, compared with a reading of 5.26 percent a month earlier.

Rates on corporate bonds moved higher as the month opened, continuing the pattern that began late in February. The unsold portions of two issues marketed around mid-February were released from syndicate restrictions at the start of the period, and the upward rate adjustments amounted to about 15 basis points. Investor response to the highly rated new issues offered early in the month was favorable, and all of the large Aa- and Aaa-rated bonds sold well at generous yields. Included among these were $125 million of Aaa-rated notes of a bank holding com-

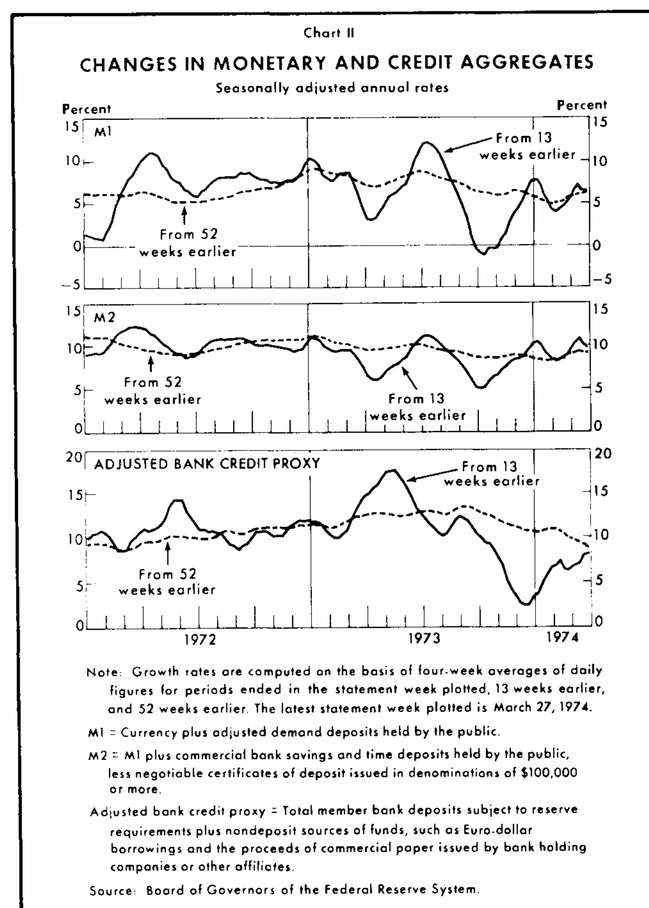

Chart II

CHANGES IN MONETARY AND CREDIT AGGREGATES

Seasonally adjusted annual rates

Note: Growth rates are computed on the basis of four-week averages of daily figures for periods ended in the statement week plotted, 13 weeks earlier, and 52 weeks earlier. The latest statement week plotted is March 27, 1974.

M1 = Currency plus adjusted demand deposits held by the public.

M2 = M1 plus commercial bank savings and time deposits held by the public, less negotiable certificates of deposit issued in denominations of $100,000 or more.

Adjusted bank credit proxy = Total member bank deposits subject to reserve requirements plus nondeposit sources of funds, such as Euro-dollar borrowings and the proceeds of commercial paper issued by bank holding companies or other affiliates.

Source: Board of Governors of the Federal Reserve System.

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pany which moved quickly after being priced to yield 7.80 percent in eight years and $125 million of Aa-rated thirty-year debentures which were snapped up at an 8.60 percent initial yield and then moved to a premium. Investors were selective, however, and some lower rated bonds moved poorly despite increased yields. Around mid-March, some general investor resistance developed and, for the second consecutive month, an Aaa-rated Bell System issue encountered difficulty. This occurred despite the fact that the $200 million of forty-year debentures yielded 8.30 percent, 24 basis points more than similar bonds marketed in February and the highest return on an Aaa-rated Bell issue in almost three and one-half years. Late in the day following their flotation, these bonds were allowed to trade without restriction and the initial upward yield adjustment amounted to 8 basis points. The initial response to the next rather large corporate issue was also cool but then, as a result of improved market sentiment, most of the remaining new corporate offerings in March were successful endeavors, albeit at decidedly higher yields than had prevailed in February.

Table II

AVERAGE ISSUING RATES AT REGULAR TREASURY BILL AUCTIONS*

In percent

Maturity	Weekly auction dates—March 1974			
	March 4	March 11	March 18	March 25
Three-month	7.675	7.920	8.047	8.300
Six-month	7.566	7.637	7.882	8.231

Maturity	Monthly auction dates—January-March 1974		
	January 9	February 6	March 6
Fifty-two weeks	6.948	6.342	6.897

* Interest rates on bills are quoted in terms of a 360-day year, with the discounts from par as the return on the face amount of the bills payable at maturity. Bond yield equivalents, related to the amount actually invested, would be slightly higher.

At the beginning of March, the Blue List of unsold municipal bonds totaled a very large $1.14 billion, and these inventories weighed heavily on the market. Two of the largest new offerings during the period were scheduled for March 5 and 6, and participants waited on the sidelines until terms for these were announced. The first of them, $150 million of A1-rated bonds, attracted broad-based demand, with yields ranging from 4 percent in 1976 to 5.60 percent in 2003. On the following day, the market also reacted favorably to the month's largest tax-exempt issue, some $227 million of Department of Housing and Urban Development New Housing Authority bonds. Priced to yield from 3.90 percent in 1975 to 5.25 percent in 2014, the bonds were considered attractive and good demand emerged. The successful marketing of these offerings sparked some interest in older issues, and prices stabilized over the next few days. Demand then began to wane, and rates moved higher throughout the remainder of the month in generally light trading. Dealers were able to pare their stocks during the period, and the Blue List of advertised inventories fell $485 million to a level of $657 million, the lowest this year.

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