The Business Situation

The most recent business statistics provide further evidence of a slowing in the economy. During the past quarter, real gross national product (GNP) edged up at a seasonally adjusted annual rate of 1.3 percent, the slowest pace in three years. In the last month of the quarter, industrial production actually declined, following three months of very small gains. Some of this recent braking clearly reflects the impact of the embargo on oil shipments from the Arab oil-producing nations, announced late last October, with all of the December decline in industrial production traceable to reductions in the output of "energy" and automotive assemblies. Actual and anticipated fuel shortages contributed to a fairly broad-based rise in unemployment from 4.8 percent in December to 5.2 percent in January.

Some slowing in the economy was generally expected even before the petroleum situation moved to center stage, and would almost certainly have taken place even if ample supplies of oil had continued to be available. Shortages were an important factor; these were widespread up to and including the final quarter. Indicative of this was the extraordinarily high level of capacity utilization in the major materials industries during the last quarter. Despite a slight decline from the third-quarter rate, the October-December figure was the second highest quarterly utilization rate on record. Price controls contributed to the shortages, since they led to changes in output patterns and also induced producers to expand exports, which are not subject to domestic price controls.

The price situation has gone from bad to worse in recent months, with prices of fuel and power skyrocketing. The rise in the GNP deflator continued to accelerate during the fourth quarter and reached an annual rate of 7.9 percent, the fastest climb since the Korean war. Wholesale prices soared at a 26 percent annual rate in December, after registering a 21 percent increase in November. A broad-based advance in all the components was evident, even though fuel and power prices, which increased at the phenomenal annual rate of 146 percent in December and 157 percent over the last three months, had an overwhelming effect on the index. For the entire year, wholesale prices rose by 18.2 percent, the highest rate since the end of World War II. Although the upward march in consumer prices "slowed" to an annual rate of 6½ percent in December, the rapid run-up in wholesale prices has not yet been fully felt at the retail level. During the past year, consumer prices climbed 8.8 percent, the fastest advance since price controls were terminated after World War II.

Cost pressures during the final quarter of 1973 intensified, as rapidly rising wages and declining productivity generated the largest unit labor cost increase in four years. Prospects for a moderating of the pace of wage changes are diminished by the fact that real wages declined over much of 1973. Moreover, a heavy collective bargaining schedule is anticipated for 1974.

GNP AND RELATED DEVELOPMENTS

The market value of the nation's output of goods and services rose $29.5 billion during the fourth quarter to a seasonally adjusted annual rate of $1,334 billion, according to the preliminary Commerce Department estimates. Measured in current dollars, GNP climbed at a 9.4 percent annual rate, but nearly all of this advance reflected higher prices; after adjustment for changes in the price level, GNP expanded at a 1.3 percent rate, the slowest pace in three years (see Chart I).

Although the Arab oil embargo had some impact on real growth during the fourth quarter, a slowing had become apparent earlier in the year. During the two middle quarters of 1973, real growth averaged about 3 percent per year, after having risen 8 percent during the twelve months ended March. A comparable deceleration in the growth of the Federal Reserve Board's index of industrial production, which measures the physical output of the nation's factories, mines, and utilities, has also occurred. Over the four quarters ended last March, the expansion in industrial production averaged close to 12 percent. It then slowed to about 6 percent in each of the next two quarters and to less than 1 percent in the final quarter. In December, industrial production registered its sharpest decline in more than two years. However, excluding the energy component, which encompasses such activities as the extraction and processing of fuels as well as the generation of power, and the motor vehicles and parts component, which has also been strongly affected by the oil situation, industrial production rose in December.

Inventory investment added $11.2 billion to the growth of GNP during the fourth quarter (see Chart II). According to estimates based on incomplete data, the change in business inventories soared from the small $4½ billion annual rate of accumulation averaged during the preceding three quarters to a huge $15.9 billion climb in the October-December period. Final expenditures—GNP net of inventory accumulation—rose only about half as fast as in the earlier quarters of 1973, as spending on consumer durables and residential construction declined sharply.

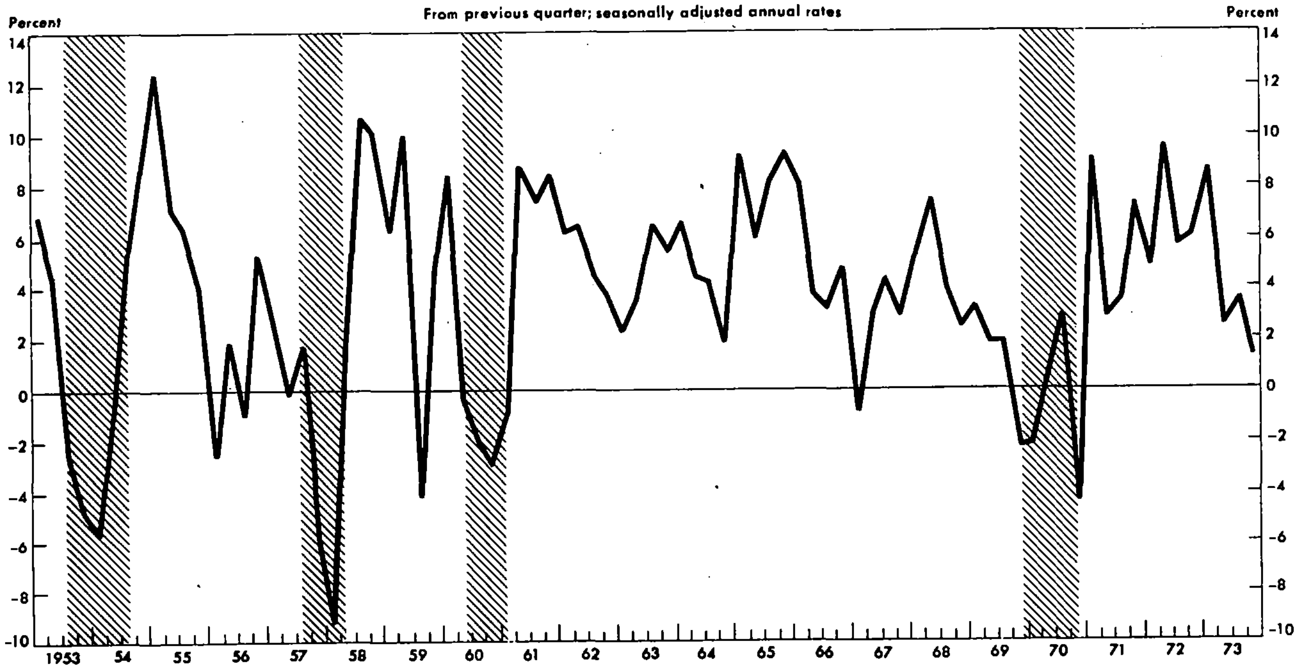
The abrupt rise in inventory investment represents the outcome of a diverse set of factors. As in the preceding quarter, there was a run-up of farm inventories ($1 billion, annual rate), with farmers probably increasing their holdings in anticipation of higher prices. Many other businessmen were undoubtedly attempting to build up inventories from the very low levels to which they had been pushed by the exceptionally rapid growth of final demand and the widespread supply shortages that have characterized much of the recent past. However, the most dramatic development was the $4.5 billion surge in passenger car inventories held by auto dealers (see table), while some of this buildup was voluntary, in response to the depletion of dealer stocks during the earlier part of the year, most of it reflects the marked weakening toward the end of 1973 in the demand for standard-size cars. As sales dropped, dealer stocks of domestic-type cars went from the equivalent of forty-two days of sales in September to sixty-nine days in December. The present imbalance of auto inventories is underscored by industry reports that supplies of certain slow-selling large vehicles currently are equal to several months of sales while for some of the much-sought-after subcompacts supplies are extremely short.

The pace of overall consumer spending slowed dramatically during the fourth quarter. Current-dollar outlays expanded by only $13 billion, compared with the $20.4 billion advance registered in the previous quarter and an

Chart I

PERCENTAGE CHANGES IN REAL GROSS NATIONAL PRODUCT

From previous quarter; seasonally adjusted annual rates



Note: Shaded areas represent recession periods, indicated by the National Bureau of Economic Research chronology. The dates of the 1969-70 recession are tentative.

Source: United States Department of Commerce, Bureau of Economic Analysis.

average increase of $19.1 billion per quarter over the year ended in June. When stripped of the sharp price increases, the recent sluggishness of consumer spending emerges even more clearly, showing an actual decline in the fourth quarter at a 2.6 percent annual rate. This was the first decline since the final quarter of 1970, when the recession and a lengthy strike at General Motors had combined to produce an even larger drop.

Current-dollar spending on consumer durables, which had shown a very sizable increase in the first quarter of 1973 and had remained essentially flat for the next six months, declined in the fourth quarter by $6 billion. Expenditures on passenger cars plummeted $7.1 billion (see table), a decline comparable in both current dollar and real terms to the drop that occurred during the auto strike of three years ago. Although some slowing in the pace of new car sales was widely anticipated well in advance of the launching of the 1974 models, the magnitude of the decline has surpassed most expectations. The Arab oil embargo and accompanying uncertainties as to the availability and cost of gasoline have taken their toll on the auto industry. They have not only weakened the demand for new cars beyond the amount of slippage that might otherwise have occurred, but have also precipitated a strong shift toward smaller vehicles. However, parts shortages and capacity limitations have constrained the production of smaller cars both at home and abroad and lengthened delivery times. Consequently, sales of new passenger cars—domestic types and imports combined—dropped from the record annual rate of 12.6 million units reached this past March to a seasonally adjusted annual rate of 9.6 million units in December. In January, sales of new domestic cars, which had been at a seasonally adjusted annual rate of 7.9 million units in December, slipped to 7.7 million units. This compares with a fourth-quarter average of 8.4 million, and a peak rate of over 10 million reached during the first quarter of the year.

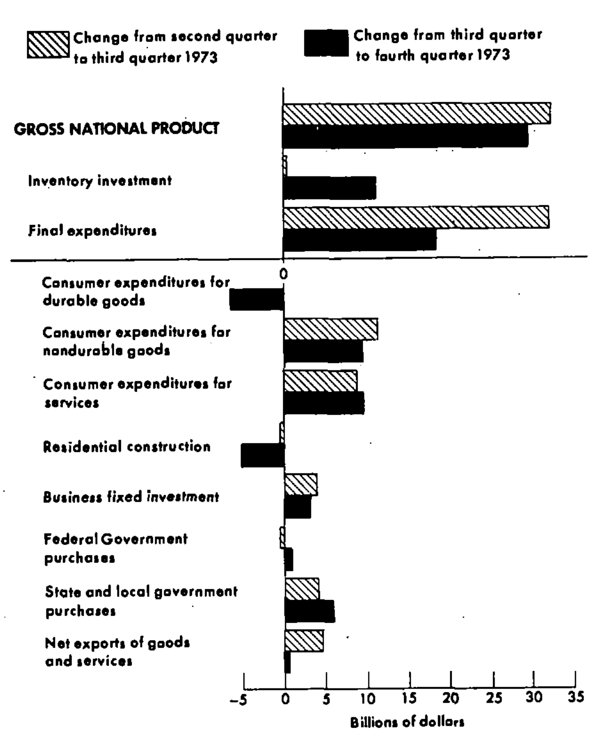
Spending on nondurable goods also weakened during the fourth quarter, with real outlays showing a decline. Although current-dollar outlays for both food and gasoline rose appreciably in the face of rapid price increases, real consumption fell in both categories. The decline was especially acute with respect to gasoline and motor oil. Expenditures for services, on the other hand, continued quite strong—both before and after adjustment for price increases.

Business fixed investment advanced by a comparatively modest $3.1 billion. This was somewhat slower than in the preceding two quarters and only about half as fast as the rapid growth during the final quarter of 1972 and the opening quarter of 1973. During October-December, business purchases of passenger cars dropped by $1.2 billion to the slowest pace in almost two years (see "producers' durable equipment" in the table). The petroleum outlook, including its implications for the resale price of larger-size cars, was at least partly responsible for this decline.

Chart II

RECENT CHANGES IN GROSS NATIONAL PRODUCT AND ITS COMPONENTS

Seasonally adjusted



Source: United States Department of Commerce, Bureau of Economic Analysis.

The important role of automotive developments in the evolution of fourth-quarter GNP is summarized in the table. These data show those portions of GNP that arise from expenditures on passenger cars. They comprise consumer spending on passenger cars, the part of business fixed investment that takes the form of passenger car purchases by business, and the portion of the change in business inventories that is accounted for by dealer holdings of cars. The difference between auto exports and auto imports (the latter including passenger cars assembled in Canada for sale in the United States) also enters into the calculation of gross auto product.

As the table shows, following the big drop in auto production during the General Motors strike near the end of 1970 and the sizable rebound immediately thereafter, auto product remained virtually flat through the first half of 1972. This was followed by a period of dramatic growth, with real auto product rising at an annual rate of more than 32 percent over the three quarters ended March 1973. This compared with a rise of less than 8 percent in total real GNP (see last line of table) over the same period. Thus, the increase in gross auto product accounted for fully 20 percent of the increase in real GNP. As 1973 wore on, however, gross auto product began to decline, contributing significantly to the slowing in overall economic activity. During the middle two quarters of the year, auto product growth was restrained by the fact that the industry was operating at or close to maximum capacity, and the third quarter was additionally plagued by a variety of supply problems. The fourth-quarter decline, as indicated above, was clearly related to the weakening in demand for the larger new cars. Although a sharp rise in dealers' inventories offset much of this decline in final demand, it is unlikely that this will continue, given the substantial downward adjustment of domestic auto production that is currently under way.

The demand for fixed investment goods as a whole still appears quite strong. The latest Commerce Department survey, which was conducted during November and December—after the announcement of the Arab oil embargo—indicated that businessmen are planning to increase their capital spending 12 percent above 1973 levels. Of course, when adjusted for anticipated price changes, the implied increase is substantially less. Nonetheless, it is interesting that the planned rise showed no significant decrease from projections made on the basis of information gathered somewhat before the oil embargo was instituted—namely, 12 percent in the Lionel D. Edie survey and 14 percent in the McGraw-Hill survey. However, many of these intentions are still tentative and may involve no firm commitment on the part of business firms.

Residential construction spending during October-December dropped $5 billion. This had been foreshadowed by monthly data showing a decline in private housing starts, which moved down from an average in the first quarter of 1973 of 2.4 million units, seasonally adjusted annual rate, to 1.6 million in the final quarter. The high cost and limited availability of mortgage financing have played an important role in reducing the volume of housing activity. However, other forces have also contributed to the decline. Some slowing was inevitable from the fever-

GROSS AUTO PRODUCT AND ITS COMPONENTS
Seasonally adjusted annual rates

Groups	1970		1971				1972				1973			
	III	IV	I	II	III	IV	I	II	III	IV	I	II	III	IV
	In billions of current dollars													
Gross auto product	34.2	22.5	42.4	40.1	42.4	38.8	40.1	42.1	46.5	45.6	51.5	51.2	49.6	45.7
Personal consumption expenditures	29.7	23.4	34.3	34.3	37.1	35.9	36.6	38.1	41.8	41.2	45.1	44.6	44.5	37.4
Producers' durable equipment	5.2	4.1	6.1	6.1	6.5	6.3	6.5	6.7	7.4	7.3	8.0	7.9	7.8	6.6
Change in dealers' auto inventories	0.3	—3.3	4.0	1.6	1.2	—1.2	—0.4	—0.4	—0.8	—0.4	0.9	1.2	—0.5	4.5
Net exports	—1.5	—2.1	—2.3	—2.3	—2.9	—2.8	—2.9	—2.8	—2.3	—2.9	—2.8	—2.9	—2.7	—3.3
	In billions of 1958 dollars													
Gross auto product	31.6	20.0	37.1	34.8	37.8	35.8	36.1	37.7	41.0	41.4	46.4	45.5	43.6	40.6
Addendum:														
Gross national product	726.8	718.0	731.9	737.9	742.5	754.5	768.0	785.6	796.7	812.3	829.3	834.3	841.3	844.1

Note: The gross auto product totals include government purchases, which amounted to $¼ billion annually during the periods shown. Because of rounding, figures do not necessarily add to totals.
Source: United States Department of Commerce, Bureau of Economic Analysis.

ish and unsustainable pace hit during 1972 and early last year. In addition, rapid increases in housing prices have probably reduced demand somewhat below where it might otherwise be. More recently, the restricted availability and increased cost of gasoline and other fuels, as well as the general uncertainties associated with the Arab oil embargo, have probably been further factors dampening housing activity. On the other hand, recent Government steps, such as that providing for expanded use of the "tandem plan", could favorably affect the near-term outlook for housing. The tandem plan allows the Government National Mortgage Association to purchase at below market interest rates up to \$6.6 billion in unsubsidized Federal Housing Administration and Veterans Administration mortgages.

Spending by state and local governments rose \$5.8 billion during the fourth quarter, up from the \$4.7 billion growth averaged during the earlier quarters of the year. Federal spending increased \$1 billion, compared with the decline of \$0.4 billion in the previous quarter and the large gain of \$2.3 billion averaged during the first half of the year. A Federal pay raise that took effect on October 1 led to a \$1.7 billion increase in fourth-quarter Federal expenditures on wages and salaries. Excluding the pay raise, nondefense spending was up \$0.7 billion and defense spending was down \$1.5 billion. However, defense spending was reduced \$2.5 billion by the sale of arms to Israel out of Government stocks, and net exports were raised by the same amount. Excluding both the pay raise and the arms shipment, defense spending was up \$1 billion.

PRICE DEVELOPMENTS

Prices took a decided turn for the worse during the fourth quarter. According to preliminary data, the implicit GNP deflator rose at a 7.9 percent annual rate, almost a full point above that recorded in the previous quarter. For the entire year, the deflator climbed 7 percent. This was more than twice the rate of increase experienced during 1972, 1½ percentage points faster than the 1969-70 period of rapid price inflation, and the strongest spurt since the Korean war.

Partly as a result of numerous changes in the price controls program, the month-to-month behavior of wholesale prices has been exceedingly erratic. On balance, the movement has been very sharply upward. Seasonally adjusted prices of farm products, processed foods, and feeds rose at a 17 percent annual rate in December, following the astronomical leap of 232 percent, annual rate, in August and large declines in each of the next three months. By December, this component had risen 27 percent above year-ago levels. The fuel and power component of the wholesale price index soared in the final three months of the year, rising at a 157 percent annual rate after climbing at a 25 percent rate during the first nine months of the year and 6 percent during 1972. Even excluding the two foregoing index components, wholesale prices have risen extremely rapidly—at a 12.3 percent rate during the last three months of 1973, compared with an 8 percent rate during the first nine months of 1973 and a total of 3½ percent in 1972.

Consumer price increases "slowed" to a seasonally adjusted annual rate of 6½ percent in December, compared with the 9½ to 10 percent range of the October and November advances. For the entire year, prices soared 8.8 percent, more than twice as fast as during 1972 and the highest annual burst in a quarter century. Food price increases tapered off sharply during the final quarter of the year, compared with the advance during January-September; in those first nine months prices soared at a 23 percent rate, and in the last three months rose at a 9 percent rate. This deceleration, however, was dwarfed by the explosion of energy prices that accompanied the Arab embargo on petroleum shipments to the United States. Prices for consumer power and fuel, i.e., gasoline, home-heating oil, and gas and electricity, which have a total weight of about 6½ percent in the consumer price index, rose at over 40 percent, annual rate, in the final three months of 1973, compared with a rise of about 8 percent, annual rate, during the first three quarters of the year.

WAGES, PRODUCTIVITY, AND EMPLOYMENT

Recent data indicate a substantial intensification of inflationary pressures during the fourth quarter, with wages rising rapidly and productivity registering an outright decline. Hourly compensation in the private economy increased at a seasonally adjusted annual rate of 8 percent, bringing the rise over the entire year to a very substantial 8.2 percent. The 1973 increase in this broad measure of wage and fringe benefits was a full point higher than the advance in 1972, and the largest since 1968. However, because of the very rapid advance in the consumer price index, real private compensation declined for the third consecutive quarter. This erosion is almost certain to put added pressure on wage demands during 1974.

Productivity, as measured by output per hour of work in the private economy, fell at an annual rate of 1.3 percent in the October-December period. Over the preceding two quarters, productivity growth had been essentially unchanged after having risen very rapidly during the previous twelve months or so. The combination of rising hourly compensation and declining productivity caused private sector unit labor costs to soar 9.3 percent in the fourth quarter, the largest increase since 1969. For the entire year, unit labor costs rose 7.2 percent or nearly three times the 2.7 percent rise averaged over 1972.

According to the Bureau of Labor Statistics survey of major collective bargaining agreements, contracts negotiated during 1973 provided, on average, first-year wage increases of 5.8 percent and life-of-contract gains of 5.2 percent. However, for wages and fringe benefits combined, first-year settlements averaged 7.1 percent and life-of-contract gains came to 6.1 percent. Moreover, the growth in compensation that will finally emerge under many of these contracts will undoubtedly be larger, since the Labor Department data do not include payments made under escalator-clause provisions that are contingent on movements in the consumer price index. Forty percent of the workers under major contracts concluded in 1973 were covered by cost-of-living escalator clauses.

A very heavy collective bargaining schedule is unfolding for 1974. During the year, 5.2 million workers, representing about half the working population covered by major collective bargaining agreements, will be involved in negotiations. Bargaining activity will be concentrated in the steel, canning, aluminum, construction, communications, electrical machinery, aerospace, longshore, railroad, and mining industries. More than a million additional workers come under contracts that, although not scheduled for negotiations this year, could be reopened in the event of a "national emergency".

The unemployment rate registered its third consecutive monthly increase in January, according to the household survey, rising to 5.2 percent on a seasonally adjusted basis. This compared with the 3½-year low of 4.6 percent reached this past October and the 4.8 percent level registered in December. A sharp January rise of 370,000 in the number of unemployed persons was the net result of a very large growth of more than 500,000 persons in the size of the civilian labor force and a very small increase of 142,000 persons in the volume of employment as measured by the household survey. Although month-to-month changes in the size of the labor force tend to be quite volatile, the growth in the labor force has, on balance, been rather vigorous. Over the year ended January, the civilian labor force increased by 3.5 million persons or close to 4 percent.

The January payroll survey recorded a second straight monthly decline in the number of persons employed by nonagricultural establishments. Seasonally adjusted payroll employment dropped by 260,000 persons to about the level reached this past October, with the decline concentrated in construction and manufacturing. At the same time, the average workweek for production and nonsupervisory workers dropped sharply. The abrupt decline of 0.8 hours brought the seasonally adjusted factory workweek to 39.9 hours, its lowest level in slightly more than two years.

Although the household and payroll surveys tend to give rather comparable employment readings over long-enough time spans, they often diverge on a month-to-month basis for a variety of reasons, including coverage, sampling techniques, and seasonal adjustments. A substantial portion of the January discrepancy between the household and payroll survey measures of employment is removed when the two surveys are examined from the vantage point of more comparable coverage. If the 150,000-person increase in agricultural employment is excluded, the January household survey shows a small employment decline.

Taken together, the direct and indirect effects of the Arab oil embargo have undoubtedly accounted for a considerable part of the January rise in unemployment, but it is impossible to tell how much. About half of the large January decline of 125,000 persons in manufacturing employment was centered in transportation equipment, where sizable layoffs have occurred among workers producing passenger automobiles. Although the evidence is preliminary, Labor Department analysts feel that actual or anticipated fuel shortages have been responsible for reducing employment in a variety of other areas also, such as gasoline stations, air transportation, automobile selling, and hotels and motels.