The Business Situation

Economic activity posted a sizable decline during the first quarter of 1974, as real gross national product (GNP) fell at a 5.8 percent seasonally adjusted annual rate, the largest quarterly decline since 1958. However, it appears that practically all of this drop reflected the impact of the Arab oil embargo which ended in mid-March. Moreover, the data suggest that the weakness in business activity did not spread widely throughout the economy but was confined largely to the automotive sector, which bore the brunt of the embargo's direct and indirect effects. During the first quarter, the decline in real gross auto product accounted for 95 percent of the drop in total real GNP. Subsequently, auto sales have apparently bottomed out and may even be on an uptrend. In addition, automobile producers have revised upward, by better than 4 percent, their second-quarter production schedules in response to the improved outlook.

On the other hand, the price situation has deteriorated even further in recent months. During the first quarter, the GNP deflator, which is the broadest available measure of price movements, soared at a 10.8 percent annual rate, the fastest climb since the Korean war, and the fixed-weight price index for GNP increased at an even more rapid rate. While skyrocketing food and fuel prices have had a very substantial impact on price data, the upward march of prices is currently taking place along a very broad front. Consumer prices rose at nearly a 13 percent rate in March, the third consecutive month of inflation in excess of 10 percent at the retail level.

The first-quarter rise in compensation per hour of work was modest in comparison with the surge in consumer prices. As a result, real wages declined for the fourth consecutive quarter. Moreover, the decline in real wages experienced over the year ended in March is bound to escalate wage demands during the latter part of the year unless labor shows remarkable restraint.

GNP AND RELATED DEVELOPMENTS

Preliminary estimates indicate that the seasonally adjusted market value of the nation's output of goods and services rose only $14.3 billion at an annual rate during the first quarter of 1974. This constitutes a 4.4 percent annual rate of increase, the smallest percentage advance in nominal GNP in about three years. Moreover, when adjusted for the enormous rise in prices that occurred during the quarter, GNP actually declined at a 5.8 percent annual rate, the largest drop in real output since the first quarter of 1958. Reflecting the impact of pervasive shortages, the growth of real GNP had slowed noticeably during the two middle quarters of 1973, well in advance of the start of the Arab oil embargo (see Chart I). While the embargo had some effect on GNP during the fourth quarter of last year, its major impact was experienced during the first quarter of this year. The embargo weighed most heavily on the automotive sector. The reduction in gross auto product, which is the portion of GNP directly attributable to the production and sale of passenger cars, represented 95 percent of the overall decline in real GNP during the first quarter. Furthermore, real farm output decreased considerably during the first quarter after rising sharply in the October-December period. Excluding both the auto and farm sectors, real GNP edged down by less than 1 percent in the January-March interval.

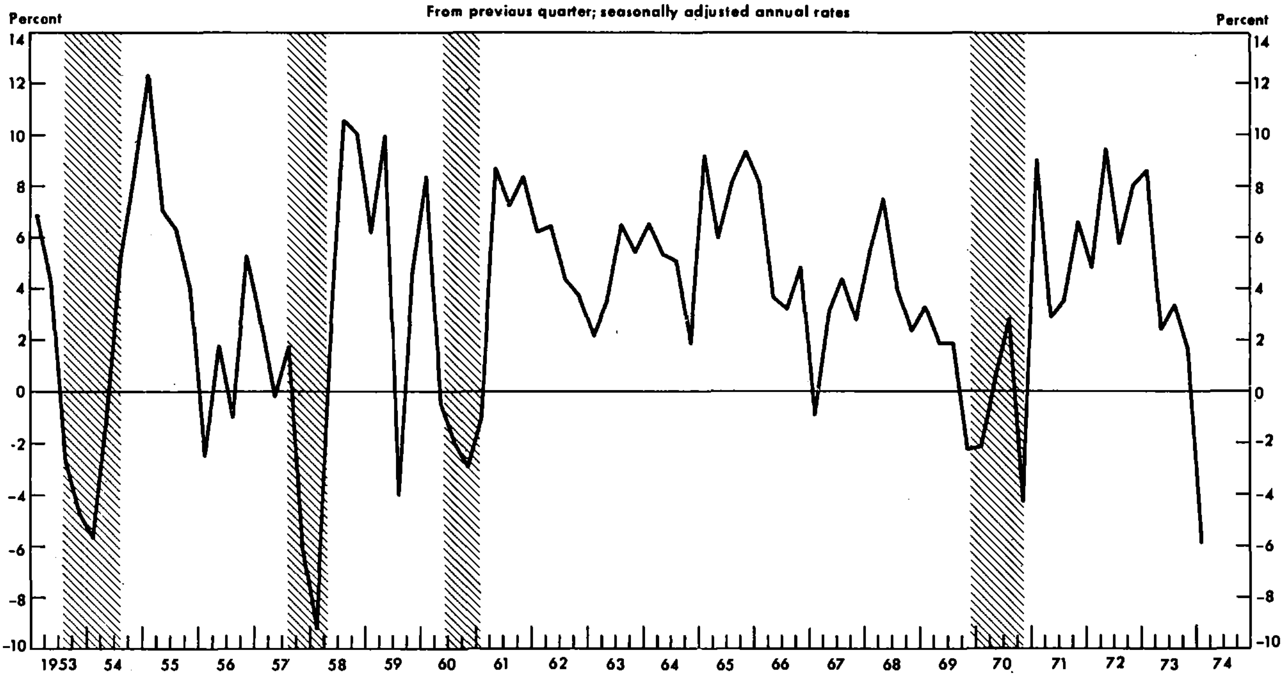
A number of factors have probably helped to keep the economic decline precipitated by the oil embargo from spreading widely throughout the economy. A sizable portion of the impact to date has fallen on the automotive sector, where many workers have had their spendable incomes protected to a degree by supplementary unemployment benefit programs. Payments from privately sponsored plans, which have been incorporated into the collective bargaining contracts covering the rank and file workers at the major auto-producing firms, are combined with state unemployment insurance benefits to maintain temporarily take-home pay for eligible workers close to that earned on the production lines. More broadly, the persistence of the shortages which developed during 1973 has probably meant that some of the easing in demand that became apparent in certain sectors toward the end of last year and early in 1974 had relatively little impact on output and income.

The modest growth of nominal GNP in the first quarter

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 Research chronology. The dates of the 1969-70 recession are tentative.

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

was accompanied by a sharp slowing in the rate of inventory accumulation (see Chart II). However, huge swings in dealer holdings of new passenger cars have obscured the extent to which inventory investment has strengthened in nonautomotive sectors. Excluding the change in dealer new car stocks, the rate of real inventory accumulation was actually somewhat stronger in the first quarter than during the previous three-month period. The change in overall business inventories, which dropped abruptly from the large $18 billion annual rate of accumulation registered during the fourth quarter to a $7.8 billion seasonally adjusted annual rate in the January-March 1974 period, does not of course reflect this. Further, while book value inventories posted very large gains during the first two months of the quarter, most of this was the result of price increases and is not included in the national income accounts estimate of inventory spending. The inventory valuation adjustment, which removes that part of the book value change due only to inflation, was huge in the first quarter.

The first-quarter increase in current-dollar final expenditures—that is, GNP net of inventory accumulation—amounted to a 7.7 percent increase at an annual rate, up from the pace of the previous quarter. In real terms, final sales actually declined at a 2.4 percent rate in the January-March period, a bit less than the 2.9 percent drop recorded over the preceding three-month interval.

Measured in current-dollar terms, consumer spending strengthened during the first quarter. Consumption rose $19.4 billion in the January-March interval, compared with the very small $9.2 billion increase of the preceding quarter. In real terms, however, consumer spending declined for the second successive quarter, although the decrease was noticeably smaller than that of the fourth quarter.

Current-dollar spending on consumer durables, which had declined by a sustantial $7.2 billion in the fourth quarter, fell an additional $1.1 billion in the first quarter of 1974. While this latest decrease continued to reflect weakness in spending on automobiles, there are tentative signs that the decline in auto sales may have bottomed out and perhaps even reversed itself. Sales of new domestic-type passenger cars reached a three-year low of 7.4 million units (seasonally adjusted annual rate) in February, remained at that pace in March, but rose to 7.8 million units in April. The more favorable automobile sales picture can be attributed, at least in part, to the increased availability of gasoline as well as to the general improvement in the fuel outlook that has accompanied the announced termination of the oil embargo.

Consumer spending on nondurable goods picked up in current-dollar terms during the first quarter, with large increases in outlays for food, beverages, clothing, and shoes. After adjustment for price increases, however, spending on nondurables edged down. At the same time, real expenditures for services showed no change, the first quarter in twenty years that spending for services failed to expand in real terms.

During the first quarter, the rate of personal saving out of disposable income dropped sharply to 6.5 percent, after climbing from 5.7 percent to 7.3 percent in the last half of 1973. This decline in the personal saving rate may reflect attempts on the part of consumers to preserve consumption levels in the face of the diminution in real personal disposable income. Real disposable income fell in the January-March quarter for the first time since the fourth quarter of 1970. With declines in payroll employment and the average workweek during the first quarter, wage and salary disbursements grew slowly in nominal terms and dropped considerably after adjustment for the upsurge in consumer prices. Higher social security taxes resulting from the increase in the taxable wage and salary base also contributed to the fall in after-tax personal income.

Business fixed investment, an area expected to contribute substantial strength to the economy in 1974, advanced only modestly in the first quarter. The gain of $2.6 billion was the smallest in more than a year and, in real terms, first-quarter fixed investment experienced a slight decline. All of the most recent rise in nominal outlays for fixed investment was in stuctures; the leveling-off of spending on durable equipment may reflect the impact of capacity constraints and shortages on the capital goods industries. Backlogs of unfilled orders on the books of nondefense capital goods producers have grown at about a 30 percent annual rate over the first three months of this year. Furthermore, the latest McGraw-Hill survey of capital spending intentions reveals that businesses are still planning a large increase in such spending in 1974. In addition, most of the first-quarter slowdown in business fixed investment reflects the decline in business purchases of passenger cars and trucks. This decline is at least partly in response to the energy situation.

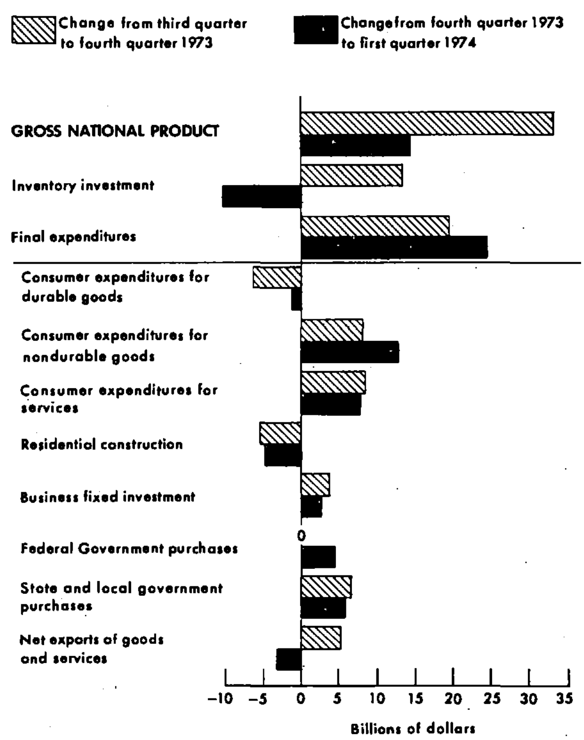
During the first quarter, residential construction spending dropped $4.5 billion. Since the peak reached in the January-March quarter of 1973, expenditures on residential structures have fallen almost $10 billion in current dollars and more than 20 percent in real terms. Seasonally adjusted housing starts dropped in March to 1.46 million units at an annual rate, the same as the January pace, suggesting that the sharp rise in starts in February was largely a statistical aberration. Permits for new construction, on the other hand, rose smoothly during the first quarter and, by March, had climbed 15 percent above the 3½-year low reached last December. However, the recent upswing in market interest rates and signs of renewed disintermediation at thrift institutions make the housing outlook highly uncertain.

Federal Government purchases of goods and services increased by $4.5 billion in the first quarter, reflecting gains

Chart II

RECENT CHANGES IN GROSS NATIONAL PRODUCT AND ITS COMPONENTS

Seasonally adjusted



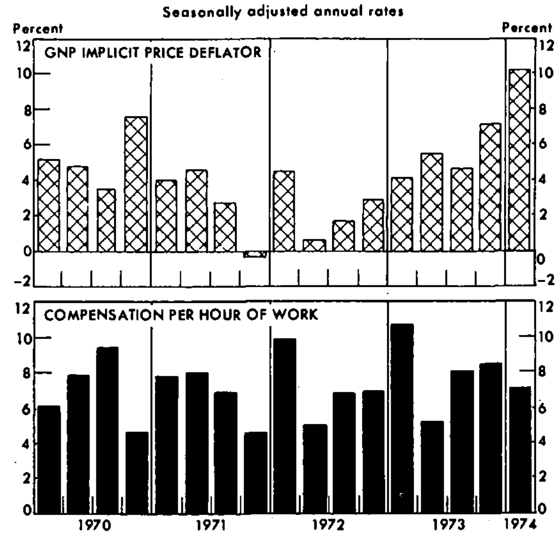
Source: United States Department of Commerce, Bureau of Economic Analysis.

of $3.2 billion in defense spending and $1.3 billion in nondefense outlays. At the same time, state and local government outlays rose $5.8 billion. During the January-March period, spending by all levels of government expanded to $296 billion, approximately 22 percent of total GNP.

PRICES

The price situation deteriorated further during the first quarter. According to preliminary data, the implicit GNP deflator rose at a 10.8 percent annual rate, 2 percentage points faster than in the fourth quarter of 1973 and the most rapid quarterly price increase in over two decades. Over the four quarters ended March 1974, the deflator climbed by an extraordinary 8½ percent. The severity of the acceleration in the rate of inflation is underscored by the fact that, during each of the preceding two years, the GNP deflator rose only about 3½ percent. A number of factors have contributed to the recent, sustained explosion in prices. Food prices continued to rise at extremely rapid rates through the first quarter. Nevertheless, the private nonfarm deflator still rose at a rate in excess of 10 percent in the same interval (see Chart III). The Arab oil embargo put very substantial upward pressure on prices of domestic energy supplies since they can serve, in varying degrees, as substitutes for imported fuels. Moreover, there is some indication that the process of gradually eliminating wage and price controls, which gathered momentum in recent months, may have contributed to the first quarter's distressing rate of inflation.

Chart III
INCREASES IN PRIVATE NONFARM PRICES AND WAGES
Seasonally adjusted annual rates



Sources: United States Department of Commerce, Bureau of Economic Analysis and the United States Department of Labor, Bureau of Labor Statistics.

Consumer prices rose at a 12.9 percent seasonally adjusted annual rate in March, marking the third consecutive month of inflation in excess of 10 percent at the consumer level. During the three months ended in March, consumer prices increased at a spectacular 13.8 percent annual rate, on top of the already very rapid 9.4 percent increase during the last half of 1973. The March increase brought the consumer price index to a level of 10.2 percent above that of a year earlier, the largest yearly surge since 1948. Almost half of the February leap in consumer prices reflected steep increases in food prices, but the March jump was more broadly based. In March, consumer food prices increased at a 9.1 percent rate, substantially slower than the February climb of 30 percent. Skyrocketing energy prices have contributed heavily to the current bout of inflation. In March, consumer power and fuel prices rose at a 47 percent annual rate, bringing the climb during the first quarter to a 57 percent pace. Nevertheless, surging prices of food and energy-related items have obscured in recent months the inflationary pressures in other areas of the economy. For example, excluding food and consumer power and fuel, consumer prices still advanced at a 7.4 percent rate during the three months ended in March, compared with a 4.6 percent rise in 1973.

WAGES, PRODUCTIVITY, AND EMPLOYMENT

Although recent information indicates a moderate increase in wages in the first quarter, cost pressures nevertheless intensified. Compensation per hour of work—the broadest available measure of wages and benefits—rose at a 7.1 percent seasonally adjusted annual rate in the private nonfarm sector of the economy during the opening quarter of this year. Including the farm sector, the advance in compensation was somewhat slower. In any event, because of the rapid escalation in the rate of consumer price increases, real hourly compensation declined in the January-March period for the fourth consecutive quarter to reach a level 2½ percent below that of a year earlier. According to the separate survey of collective bargaining agreements covering 1,000 or more workers, contracts settled during the first quarter of the year provided, on average, for first-year wage and benefit gains of 6.9 percent and for improvements over the life of the contract of 5.9 percent. While seemingly on the modest side, it should be noted that these figures do not include those payments made under escalator clauses contingent on movements in the consumer price index. About half the workers for whom major agreements were concluded during the first quarter had such clauses in their contracts. Moreover, the collective bargaining data for the first three months of the year encompassed only 466,000 of the more than 5 million workers covered by major contracts for which wages can be negotiated this year.

As measured by real output per hour of work, private nonfarm productivity declined at a 3.4 percent annual rate in the first quarter. This dip in productivity, coupled with the rise in compensation, resulted in an increase in private nonfarm unit labor costs during the period of 11.1 percent at an annual rate. Short-term movements in output per hour of work typically reflect variations in the rate of real economic growth. For example, over the four quarters ended in March 1973, real private nonfarm output rose a substantial 9 percent and productivity grew by a healthy 5.3 percent. During the next three quarters, when real output increased at a much slower 2.7 percent pace, output per hour of work actually edged down. The sharp productivity drop in the first quarter of this year, doubtless related to the Arab oil embargo, stems from the fact that the decrease in real output was considerably larger than the decline in hours worked. One possible reason for the disparity between the declines in output and hours is that firms were reluctant to make commensurate reductions in employment and hours in the face of what was viewed as a largely temporary situation.

After climbing from 4.6 percent last October to 5.2 percent in January, the unemployment rate subsequently steadied in February and then edged lower in the two succeeding months. The seasonally adjusted unemployment rate dropped to 5 percent in April, the same level that prevailed in the corresponding month last year. The recent declines in unemployment occurred largely as a result of contractions in the labor force amounting to 60,000 persons in March and a further 180,000 in April. It is important to note, however, that these reductions were preceded by sizable increases, so that the labor force was 2.3 percent larger in April 1974 than it was twelve months earlier. Over the two months ended in April, the teen-age labor force fell by 280,000 and the adult male work force by 247,000, but the adult female labor force jumped by 283,000 persons. While the modest decline in the unemployment rate was unexpected in light of the slowdown in business activity, it should be noted that the cyclically more meaningful unemployment rate for married men edged up in April, reaching a level last recorded in March 1970. Since November, the unemployment rate for married men has inched slowly upward.

In the April payroll survey of nonfarm establishments, seasonally adjusted employment increased by 126,000, bringing the rise since the end of 1973 to a total of 285,000. Manufacturing employment, which had fallen steadily since November, rose significantly and accounted for 75,000 of the April advance. About two thirds of the rise in manufacturing employment was centered in the transportation equipment sector, where recalls of automotive workers boosted employment during the month. Although there was a sharp drop in the average workweek and, particularly, in manufacturing overtime hours in April, this may largely reflect the fact that the Friday and Saturday preceding Easter, when many employees traditionally work reduced hours, were included in the survey week.