The Business Situation

Economic activity dropped somewhat further in the third quarter. The gross national product (GNP) declined, after allowing for price changes, for the third consecutive quarter according to the preliminary estimate. Since its peak in the final three months of last year, real GNP has dropped about 3 percent, comparable to declines recorded during postwar recessionary periods. Other major indicators have shown somewhat less weakness this year, however. Thus, industrial production was about unchanged in the third quarter and is, so far, down only about 1.6 percent from its November 1973 peak. Employment actually rose a bit in the third quarter and in the year to date as a whole. While the third-quarter decline in overall real GNP apparently reflected mainly a rather sharp downward adjustment of inventories, there are few, if any, real signs of increased strength in the major demand sectors. Residential construction continues at depressed levels, and consumer confidence is apparently at a very low ebb. The continued sluggishness in the economy is being reflected, as had been widely expected, in rising unemployment, with the overall rate reaching 6 percent in October.

In the meanwhile, inflation remains exceptionally severe, although there are perhaps a few straws in the wind to suggest that some relief may be forthcoming. The GNP implicit price deflator, one of the broadest measures of prices, rose at an 11.5 percent annual rate in the third quarter. Except for the first three months of this year, this was the most rapid increase since the Korean war period. The fixed-weight deflator, which is unaffected by changes in the composition of output, rose at an even more rapid 12.8 percent annual rate over the July-September interval. However, as the quarter closed, there were signs of some easing of price pressures at the wholesale level. After registering the largest increase of the year in the previous month, wholesale prices in September rose only 1.1 percent at a seasonally adjusted annual rate. While the marked deceleration resulted mainly from a decline in farm and food product prices, the 12.4 percent annual rate of increase in wholesale prices of industrial commodities was the smallest since last October. Prices of a number of raw industrial commodities have continued their generally downward trend as a result of receding demand pressures in this country and abroad. However, such prices are only a small part of the costs of finished goods, which reflect accelerating wage costs as well. Hence, at the retail level prices have continued to surge, rising at a 15 percent annual rate in September.

GROSS NATIONAL PRODUCT AND RELATED DEVELOPMENTS

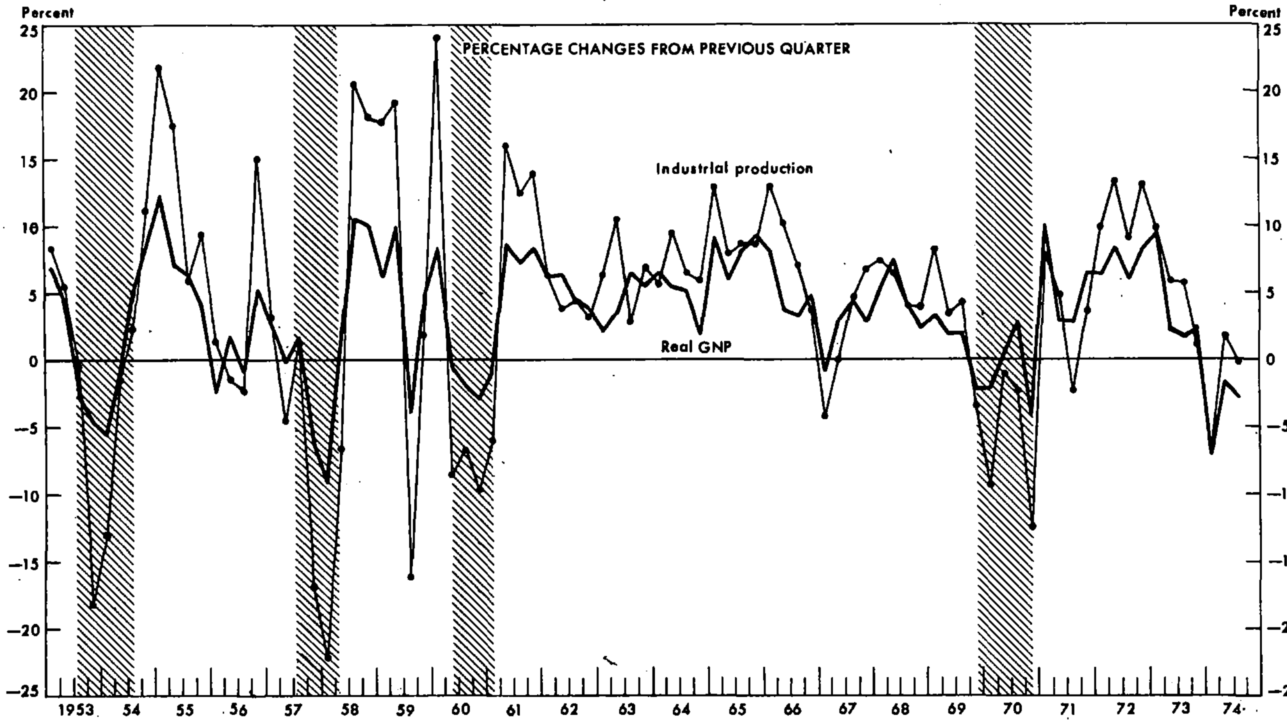
According to preliminary Department of Commerce estimates, the market value of the nation's output of goods and services rose by $27.8 billion in the third quarter of 1974, an 8.3 percent annual-rate increase. All of this rise, however, reflected higher prices, as real GNP declined at a 2.9 percent annual rate. Combined with the decrease of the two previous quarters, real GNP in the third quarter was down almost 3 percent from the peak attained at the end of last year. Thus far, the 1974 contraction in economic activity has deviated somewhat from the pattern of previous slowdowns, in which the decreases in real GNP were accompanied by even greater drops in industrial production (see Chart I). This time, the decrease in industrial production has been modest in comparison with that in real GNP and with its own behavior in previous cyclical declines. Industrial output in September was only 1.6 percent below its November 1973 peak, and this amounted to between one eighth and one fifth of the peak-to-trough contractions that occurred in 1969-70, 1960-61, 1957-58, and 1953-54.

Several factors have contributed to the recent atypical behavior of real GNP and industrial production. First, much of the decline in real GNP this year has reflected the very sharp contraction in residential housing activity. While home construction has typically fallen during cyclical declines, the recent drop has been unusually severe. This drop has had little effect on overall industrial production, with the exception of the decline in the output of construction materials and, perhaps, of the related dip

Chart I

REAL GROSS NATIONAL PRODUCT AND INDUSTRIAL PRODUCTION

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.

Sources: United States Department of Commerce, Bureau of Economic Analysis, and Board of Governors of the Federal Reserve System.

in the production of household appliances and furniture. Second, substantial buildups occurred in 1973 in the stocks of unfilled orders for durable manufactured goods and in unspent capital appropriations. No doubt these enlarged backlogs have cushioned production in recent months.

One of the major factors retarding the economy in the third quarter was the diminished rate of business inventory accumulation (see Chart II). Preliminary estimates based on partial data for the quarter indicate that investment in inventories amounted to only $5.8 billion in nominal terms in the July-September period, down from the $13.5 billion rate of accumulation of the previous quarter. In real terms, only durable manufacturing and farm stocks increased significantly in the third quarter. At the same time, the increase in current-dollar final expenditures—GNP excluding inventory investment—accelerated a bit to $35.5 billion, the biggest gain since the first quarter of last year.

Over the first nine months of this year, the pace of inventory investment has fallen off sharply from the unsustainable rate of accumulation recorded in the closing three months of 1973. In real terms, the decline in inventory spending in the first three quarters of the year has accounted for slightly more than two thirds of the total drop in aggregate demand. Businesses have continued to add to their stocks, however, and this has led to a steep runup in the ratio of real inventories to real final sales (see Chart III). In contrast, over this period, the ratio of book value inventories to total manufacturing and trade sales has remained fairly constant. To a large extent, the rapid rate of inflation has been the main factor behind the disparate behavior of these two indicators of inventory conditions, although there are other measurement and coverage differences. Much of the book value of inventories is valued in terms of past prices. Hence, in a period of rapid inflation, the book value of inventories will only incompletely reflect the higher market prices of inventoried goods. This imparts a downward bias to the ratio of book-value inventories to manufacturing and trade sales during inflationary periods, since the latter are valued more nearly in terms of current market prices.

In view of the rising ratio of real GNP inventories to sales, the decreased rate of inventory spending may well represent a more or less orderly adjustment to rates of inventory accumulation consistent with present sluggish economic conditions. On the other hand, the recent switch by many businesses from first in-first out (FIFO) accounting to last in-first out (LIFO) may have artificially depressed the preliminary estimate of inventory accumulation in the third quarter. Other things being equal, an increase in the percentage of firms using LIFO implies a slower rate of gain in book value inventories. This effect should be offset by the inventory valuation adjustment (IVA) that is applied to the book value of inventories, measured partly in current prices and partly in terms of past prices, in order to obtain GNP business inventories, measured in current costs. However, the IVA is based on the mix of firms using LIFO and FIFO in the 1960's. An increase in the use of LIFO would lower the estimate of the IVA and thereby raise GNP inventory accumulation.

During the July-September period, personal consumption expenditures rose in both nominal and real terms. Following three consecutive quarterly declines, real outlays on consumer nondurable goods posted an increase in the most recent quarter. Likewise, consumers stepped up their spending on new automobiles. Domestic automobile sales climbed to an annual rate of 9.1 million units during the middle of the quarter, up from an average of 7.9 million units in the second quarter of the year. Much of this increase, however, appears to have resulted from the efforts of consumers to avoid the price hikes on the new 1975 models. Indeed, unit automobile sales fell sharply to 6.4 million units at an annual rate in October.

Personal consumption expenditures have contributed to the recent weakness in real GNP to a larger extent than in previous periods of economic downturn. In constant dollars, personal outlays on goods and services in the third quarter were $8.7 billion below the peak level of a year ago. The decline in real disposable income, as a result of the 12 percent hike in the prices of consumer goods and services and of the rise in unemployment, has been even more dramatic. The $21 billion drop in real spendable income over the last three quarters has been three to five times greater than declines experienced in the four post-Korean war recessions. Moreover, as consumer buying power continues to fall, an increasing proportion of consumer expenditures has been financed at the expense of personal savings; the personal saving rate declined to 6.5 percent in the third quarter, down from the 9.5 percent rate prevailing a year earlier.

Residential construction spending declined further in the third quarter. Following the modest $0.4 billion rise in the preceding period, outlays on residential structures dropped at a $2.5 billion seasonally adjusted annual rate in the July-September period. Because of the lag between the time when new housing units are started and the time of completion, the third-quarter decline in construction spending in part reflected the fall in starts in earlier months of the year. In addition, housing starts in the third quarter averaged about 25 percent below the rate of the first six months of the year and permits for new units dropped in September to the lowest level in nearly eight years. While the housing sector may be helped in the future by the decline in interest rates and by the Administration's new program wherein some $3 billion will be channeled

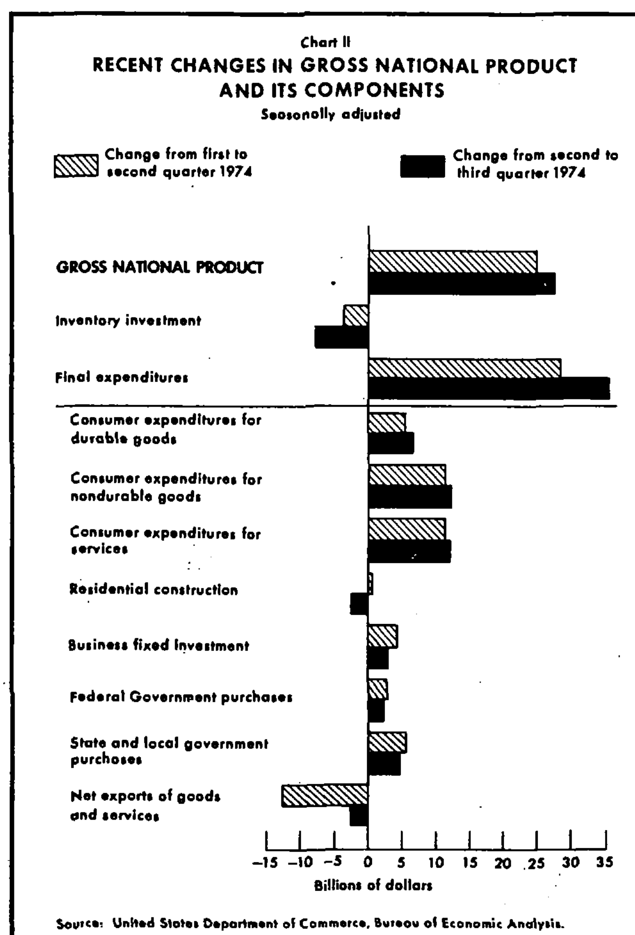
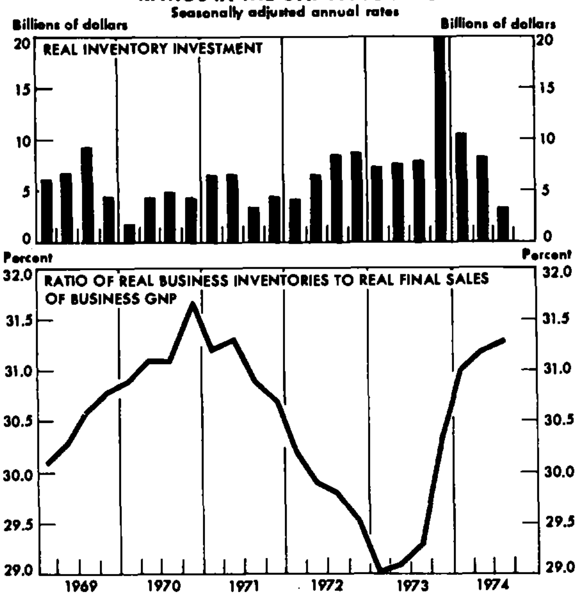


Chart III
REAL INVENTORY INVESTMENT AND REAL INVENTORY-SALES RATIOS IN THE GNP ACCOUNTS
Seasonally adjusted annual rates



Source: United States Department of Commerce.

to the mortgage market, the most recent statistics afford little encouragement about the near-term outlook.

In nominal terms, business spending on plant and equipment increased $3.1 billion during the July-September period, somewhat below the increase of the second quarter. A drop in expenditures on business structures was responsible for the slowing. Capacity utilization in manufacturing has fallen off in recent quarters, perhaps relieving pressure for immediate investment in buildings and equipment. In the third quarter, factories operated at 79.2 percent of capacity, down from 80.1 percent in the prior three months and the lowest level of utilization in two years. However, an early survey of planned plant and equipment spending in 1975 seems somewhat more encouraging. Outlays are expected to increase by 10 percent in that year, according to the survey prepared by Lionel D. Edie & Company Incorporated. This is close to the 12.5 percent increase expected this year. Of course, if the economy weakens significantly further, these plans may be pared back.

Government purchases of goods and services rose by $6.8 billion in the most recent quarter, compared with $8.1 billion in the previous three months. The $2.1 billion increase in Federal Government outlays centered in national defense spending. State and local government expenditures rose by $4.7 billion at a seasonally adjusted annual rate over the third quarter, down from the $5.3 billion increase in the second quarter of the year.

PRICE DEVELOPMENTS

Inflation remains a severe problem. The advance of the GNP implicit price deflator accelerated to an 11.5 percent annual rate in the third quarter. This was above the 9.4 percent rate of the second quarter and close to the first quarter's 12.3 percent annual-rate increase, the most rapid since the Korean war period. Farm prices declined slightly on balance over the period, but the implicit price deflator for the private nonfarm economy as a whole jumped 12.8 percent at an annual rate. The fixed-weight GNP price index, which is unaffected by changes in the composition of output, surged at a 12.8 percent rate in the July-September period.

At the wholesale level, price increases moderated a bit toward the end of the quarter. Following very rapid increases in July and August, seasonally adjusted wholesale prices registered a modest 1.1 percent annual-rate advance in September, the slowest climb in nearly a year. The index of wholesale agricultural prices declined 21 percent at an annual rate in that month, as the prices of animal feeds, grains, and livestock moved lower. However, since September, there have been signs of renewed pressure on wholesale food prices. Between mid-September and mid-October, prices received by the nation's farmers climbed at an annual rate of 47 percent, after falling by half that amount over the previous monthly period.

Some slowing was evident in the advance of wholesale industrial prices in September. Whereas these prices had risen at almost a 33 percent annual rate during the first eight months of the year, they increased at a 12.4 percent pace in September, with higher prices for machinery, chemicals, metals, and furniture and household durables accounting for most of the advance. By stage of fabrication, most of the September deceleration in industrial wholesale prices occurred at the crude and intermediate stages; the wholesale prices of consumer and producer finished goods continued to rise at fairly rapid rates.

Further easing in price increases at the wholesale level was evident in the latest survey conducted by the National Association of Purchasing Management, Inc. In October, 61 percent of the purchasing agents reported higher prices, down from 68 percent in September. Moreover, 12 percent of those reporting said they paid lower prices, up from 7 percent in September and only 2 percent in August. Hence, there are now fewer reports of higher prices than at any time since July 1973, a period when prices were frozen, and the percentage of reports of lower prices is the largest in twelve years.

At the consumer level, prices continued to surge ahead in September, rising at a 15 percent annual rate to a level 12.1 percent above that of a year earlier. This constituted the largest yearly increase since 1947. Food prices led the September spurt, rising at a 22.3 percent annual rate, but the increases in prices of other consumer commodities and in services were not far behind. Prices of nonfood commodities rose at a seasonally adjusted annual rate of 12 percent during the month, primarily as a result of sizable increases in the prices of used cars and household durables. About one fourth of the 13.2 percent rise in prices of services was attributable to an increase in mortgage interest rates.

WAGES, PRODUCTIVITY, AND EMPLOYMENT

Cost pressures accelerated in the third quarter, as labor pressed for higher wage and benefit gains in the face of continuing inflation. Compensation per hour worked, which includes wages and fringe benefits, rose in the private economy at a seasonally adjusted annual rate of 10.6 percent, up from the average increase of 8.6 percent in the previous four quarters. However, the strong rise in compensation failed to offset recent consumer price increases. Measured in real terms, hourly compensation in the private sector declined by 2.4 percent at an annual rate.

According to a separate survey of collective bargaining agreements covering 5,000 or more workers, contracts settled in the third quarter provided for an 11.9 percent annual rise in wages and benefits over the first year of the contract and 7.9 percent annually over the contract life. In contrast, the second-quarter increases averaged 9 percent and 7.5 percent, respectively. For wages alone, first-year increases in contracts containing escalator clauses averaged 10.1 percent in the third quarter but actually yielded 10.4 percent before the end of the quarter because of the immediate effects of some escalator provisions. Since the beginning of the year, wage gains from escalator clauses have been substantial. New contracts with clauses signed during the first quarter of 1974 contained a fixed first-year wage boost of 6.4 percent. Through September, these contracts have yielded an average increase of 10.4 percent as a result of escalator payments.

Despite the larger initial wage increases, contracts settled during the third quarter provided for smaller average annual-wage increases over the life of the contract than those negotiated in the second quarter. The rise in escalator coverage, which included 49 percent of the workers involved in major settlements in the third quarter versus 44 percent in the April-June period, might account for the slight drop in wage increases over the life of the contract. Escalator pacts generally call for smaller fixed raises in expectation of larger increases through the escalator adjustment.

Output per hour worked in the private economy fell 2.8 percent at an annual rate in the third quarter. The decline in productivity, coupled with the sharp increase in hourly compensation, pushed unit labor costs ahead at a 13.9 percent annual rate during the third quarter, similar to the rise over the preceding three-month period.

The rise in the seasonally adjusted unemployment rate from 5.8 percent in September to 6 percent in October reflected the continued sluggish pace of the economy. In October, as in the previous month, about one half of the increase in unemployment resulted from job layoffs. The layoffs occurred primarily in the automotive industry and related sectors. Since mid-October, when the employment statistics were collected, automotive manufacturers have announced additional cutbacks in employment. Among age groups, the jump from 3.9 percent to 4.3 percent in the jobless rate of adult men accounted for most of the latest rise in the unemployment rate. The jobless rates for teen-agers and women were little changed from their September levels. Total employment was virtually unchanged in October, while the civilian labor force increased by 174,000 persons. Despite the slow pace of economic activity, employment has expanded by 842,000 workers since December 1973. Over the same period, the labor force increased by a substantial 2 million persons.

In the separate October survey of nonfarm establishments, the labor picture was much the same. Total payroll employment was basically unchanged over the month. However, manufacturing employment fell by 84,000 persons largely as a result of the automotive industry layoffs, and employment in the construction industry fell by 30,000 persons. In October, as in the previous nine months, the weakness in both construction and manufacturing employment was offset by increases in employment in the trade and services industries.