The Business Situation

Economic activity has continued to decline, extending the duration of this most severe of the postwar recessions. In recent months the contraction has been primarily the result of a massive turnaround from inventory building to inventory liquidation, as firms have attempted to bring stocks into line with sales. The inventory correction currently under way is an essential element in setting the stage for future recovery. While the timing of the recession's end remains uncertain, a few encouraging signs have begun to appear in the economy. Consumption spending in recent months has shown tentative signs of renewed strength. While post-rebate car sales have been disappointing, the freewheeling fall in automotive sales appears to have bottomed out. Moreover, consumers have actually stepped up their purchases of other goods and services. No doubt further impetus to consumption spending will come from the recently passed tax reductions, which will add about $20 billion to disposable income. In addition, the substantial recovery in the stock market, amounting to more than 40 percent since early December, will probably also contribute to some pickup in consumer spending.

In the first quarter, real gross national product (GNP) dropped at a 10.4 percent annual rate, the steepest quarterly decline on record, to a level 7.5 percent below the peak attained at the end of 1973. While reductions in business fixed investment and residential construction contributed to the first-quarter fall, substantial inventory disinvestment was the major factor. Although inventory liquidation will probably persist for some time, it is unlikely to exert such a large drag on overall activity again. Conditions in the labor market deteriorated somewhat further in April as the unemployment rate rose from 8.7 percent to 8.9 percent. However, total employment increased for the first time in seven months.

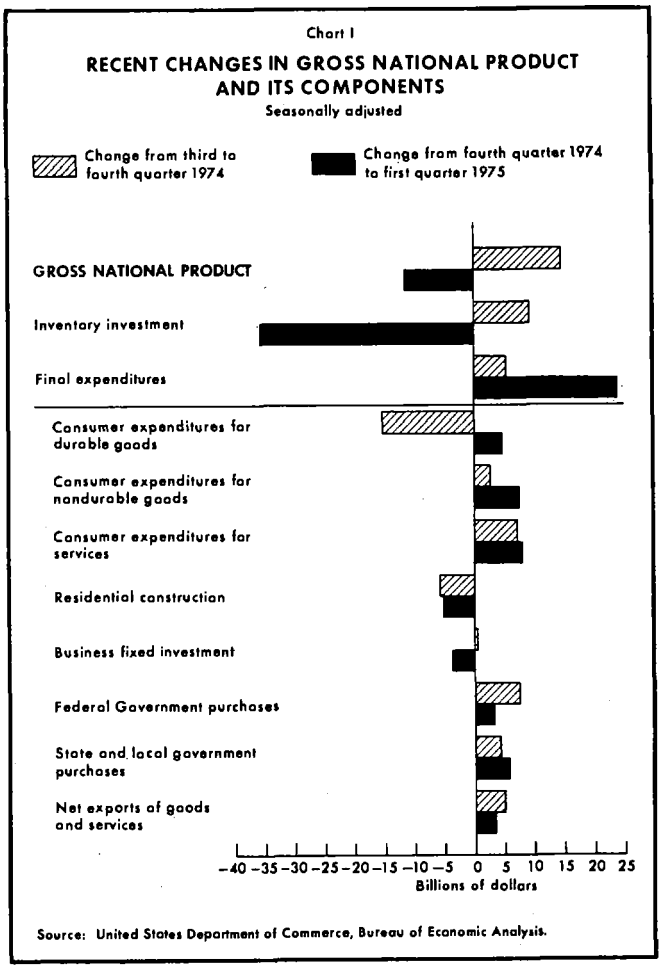
In recent months, there has been noticeable improvement in the price situation. The implicit price deflator for GNP rose at an 8 percent annual rate in the first quarter, the slowest advance since the second quarter of 1973. Much of this deceleration reflected the sharp plunge in farm prices. The implicit price deflator for the private nonfarm business sector increased at an 11.8 percent annual rate in the first three months of the year, down only modestly from the 13.2 percent rate of inflation recorded in the last quarter of 1974. Wholesale prices of industrial commodities have lately shown significant improvement, however. During the first quarter, these prices increased at a 5 percent annual rate, on average, well below the 7.9 percent advance of the previous quarter. In contrast, the slowdown in the rise of retail prices was much less pronounced. In all likelihood, however, the full impact of the moderation in nonfood wholesale prices has not yet been registered at the consumer level.

GROSS NATIONAL PRODUCT AND RELATED DEVELOPMENTS

According to preliminary data released by the Department of Commerce, the market value of the nation's output of goods and services declined by $11.7 billion during the first quarter to a seasonally adjusted annual rate of $1,419.2 billion. This amounted to a 3.2 percent annual-rate decline and was the first drop in nominal GNP in over fourteen years. Moreover, after correcting for changes in the price level, real GNP fell at a 10.4 percent annual rate, the fifth consecutive quarterly decline in real output and the sharpest quarterly reduction on record. (Quarterly GNP data extend back to 1946.) Thus far, real output has fallen 7.5 percent below the peak attained at the end of 1973.

The sizable liquidation of inventories was the most important factor affecting GNP in the first quarter (see Chart I). According to preliminary estimates based on partial data, total business inventories were pared at an $18 billion annual rate, creating a huge $35.8 billion swing from the rate of investment in the previous quarter. In contrast, current-dollar final expenditures—GNP excluding inventory investment—actually rose by $24 billion in the first quarter, compared with an increase of only $5.5 billion in the fourth quarter of 1974.

The liquidation of excess stocks was spread across all



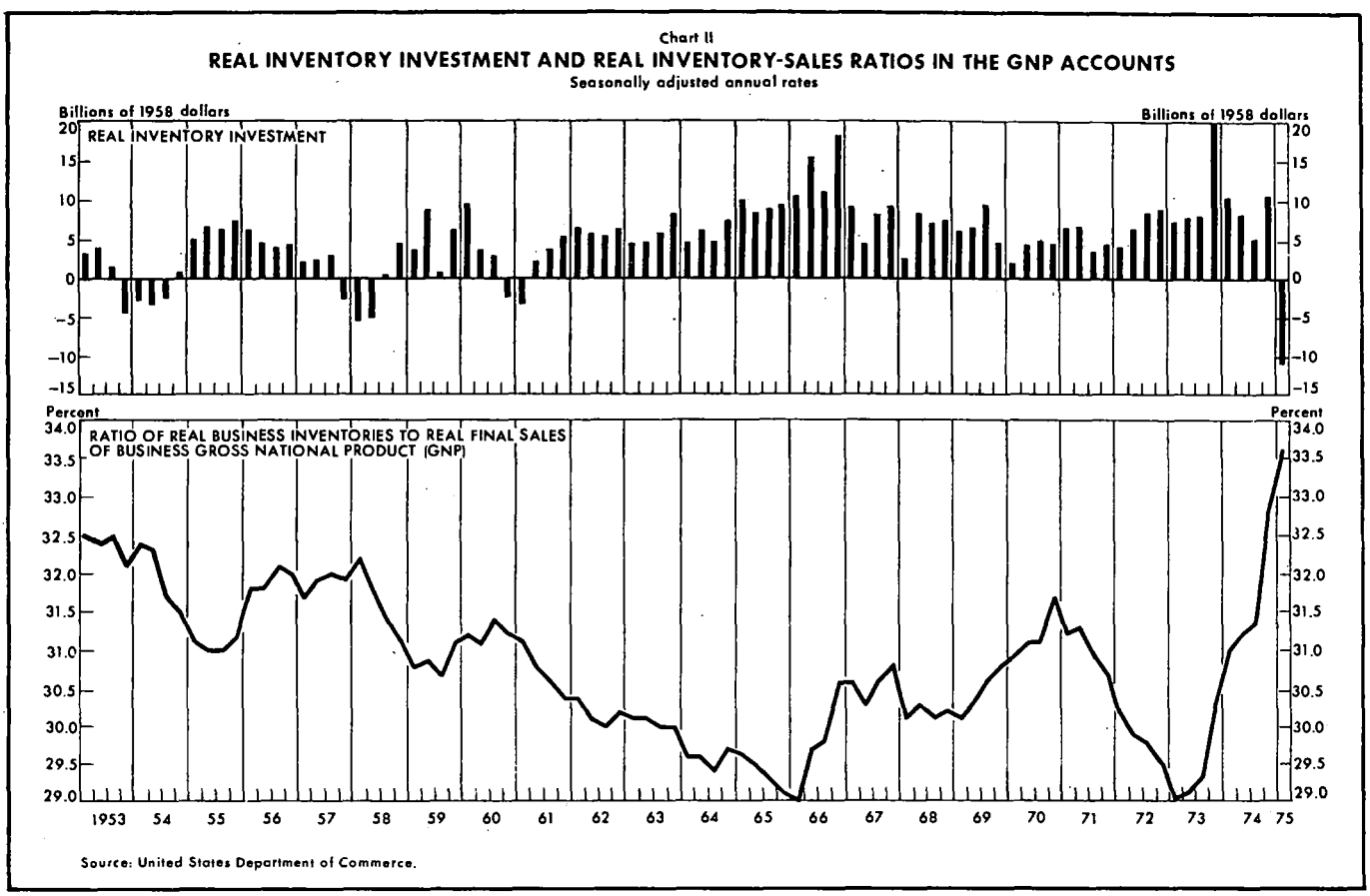
the major sectors. Stocks of durable and nondurable manufactured goods were reduced $11.2 billion and $6.8 billion, respectively, while farm inventories fell $1.6 billion at an annual rate. All the rundown in durables stocks occurred in the automotive sector. Last November, faced with a sales slump and a record 102 days' supply of automobiles, domestic manufacturers drastically cut production. However, little dent was made in the overhang of unsold automobiles until the price rebates on new cars were instituted in January. Sales then perked up in response to the lower effective prices, and car inventories were gradually drawn down, easing to 68 days of sales by the end of March. Despite this correction, the stock of nonfarm inventories, including unsold automobiles, still appears to be on the high side, and some further paring will undoubtedly take place in coming months. In the first quarter, based on GNP data, the real inventory-sales ratio for the nonfarm sector climbed to the highest level since 1952 (see Chart II). Moreover, according to the March survey of the National Association of Purchasing Management, about 50 percent of the respondents reported that they expected to continue working off excess stocks in coming months. While this suggests that further inventory liquidation is in prospect, there is a basis for believing that the worst has passed and that inventory investment will be a less severe drag on the economy in the months ahead. Indeed, disinvestment in the first quarter was so large that inventories would have to be reduced at three times the $18 billion annual rate of the first quarter to exert an equal drag on GNP.

Personal consumption spending exhibited renewed growth in the first quarter, rising by $20.5 billion. While in real terms the increase amounted to a modest $4.1 billion, this was still a vast improvement over the huge $19 billion plunge that occurred in the previous quarter. To a large extent, this pattern reflected the movements in consumers' purchases of durable goods, particularly automotive goods. However, even excluding autos, consumer durables spending managed to post a modest advance in the first quarter. The anticipation of the income tax rebates, as well as the publicity given to widespread price rebate programs, was probably influential in boosting consumption. Moreover, these factors may also have contributed to some recent improvement in consumer attitudes. For instance, The Conference Board survey conducted during January and February pointed to a rise in consumer sentiment of 11 percentage points. In coming months, consumption spending should receive additional impetus from the recently passed tax reductions. In all, about $20 billion will be added to disposable income in 1975, of which $8 billion will be derived from the income tax rebates. While consumers initially may choose to save this increment or use it to repay debt, it may eventually be used to purchase goods and services that they might not otherwise have purchased. Consumption spending will no doubt be a key element determining both the timing and vigor of the prospective economic recovery.

Residential construction spending declined by $5.2 billion in the first quarter, leaving expenditures on new housing about 40 percent below the peak reached in the second quarter of 1973. Much of the decline, however, is attributable to the sharp slide in housing starts that occurred throughout the second half of 1974. New housing starts leveled off during the first quarter at an average annual rate of 988,000 units. This is well above the depressed December figure of 880,000 units and suggests that the bottom of the current housing slide may have been reached. With a sizable volume of funds flowing

into thrift institutions, housing should receive some stimulus in coming months. In the first quarter the nation's thrift institutions are estimated to have gained deposits at a rate more than double that averaged over the last half of 1974. Despite these inflows, an outright advance in new home construction has not yet developed. Before the long-awaited recovery can begin, thrift institutions will have to rebuild their liquidity positions and the large backlog of unsold new homes will have to be reduced. Building permits continued to fall during the January-March period, declining to the lowest level on record.

Business fixed investment fell by $3.8 billion in the January-March period, the first outright decline since a strike in the automobile industry depressed business investment in the last quarter of 1970. In real terms, the drop was even greater, as constant-dollar expenditures on structures fell by $0.8 billion, while spending on equipment declined by $4.3 billion. Businesses have apparently reduced their capital spending plans as well. According to the most recent Commerce Department survey, taken during January and February, spending on new plant and equipment is expected to rise 3.3 percent in 1975. Not only is this less than the 4.6 percent rise projected in the preceding Commerce survey but, after allowing for expected increases in capital goods prices, it also represents an 8.5 percent decline in real business outlays. The latest McGraw-Hill survey also projects that real capital spending will fall in 1975 but only by 5 percent. In current dollars, business spending reportedly will rise by 5 percent over the 1974 level with more than half the total amount allocated toward modernization and replacement of plant and equipment rather than expansion. This reluctance to add to capacity is not surprising since a great deal of idle capacity currently exists. In the first quarter, manufacturers were producing at only 68.3 per-

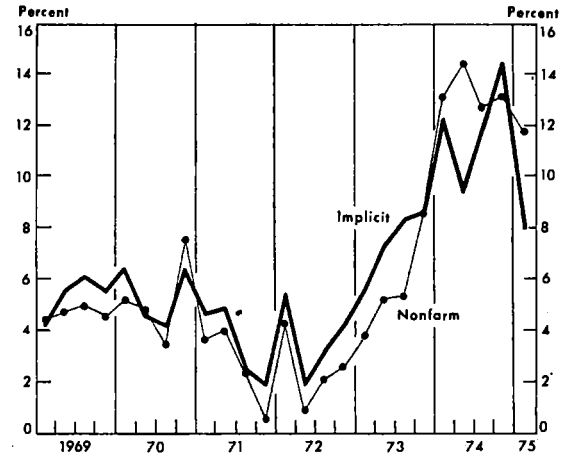


cent of capacity and, in the sensitive major materials industries, plant utilization fell to 70.7 percent, the lowest level since the second quarter of 1958. In any event, the rise in the investment tax credit included in the tax-cut legislation might provide some stimulus to investment later in the year.

Government purchases of goods and services rose by $9 billion in the first quarter, compared with $11.5 billion in the previous quarter. Federal outlays advanced by $3.2 billion, or less than half the increase posted in the fourth quarter, while state and local outlays rose by $5.8 billion. In real terms, outlays at each level advanced by $1 billion.

Finally, net exports rose by $3.5 billion in the January-March period despite the fact that both exports and imports declined. A $4 billion reduction in exports was due entirely to a drop in exports of services. Agricultural exports increased sharply during the first quarter, while exports of other goods remained strong. Meanwhile, imports fell by $7.6 billion, the second consecutive quarter in which imports have declined. With the exception of capital goods, imports of all goods and services were weaker. Petroleum imports, which fell by 12 percent during the January-March period, registered the sharpest drop. If anything, the overall improvement in net exports suggests that the recession has been more severe in the United States than it has been abroad.

Chart III
THE IMPLICIT AND PRIVATE NONFARM GNP DEFLATORS
Changes from previous quarter at seasonally adjusted annual rates



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

PRICE DEVELOPMENTS

Inflationary pressure showed further signs of easing in the first quarter. As measured by the implicit GNP deflator, prices of goods and services rose at an 8 percent seasonally adjusted annual rate. Although this remains intolerably high, it was sharply below the 14.4 percent advance of the previous quarter and was the slowest rate of advance since the second quarter of 1973. However, this improvement was distorted somewhat by the dramatic fall in farm prices. Thus, the implicit price deflator for the private nonfarm economy rose at an 11.8 percent annual rate in the January-March period, a mild improvement over the 13.2 percent increase recorded in the final quarter of 1974 (see Chart III). The fixed-weight GNP price index, which is unaffected by changes in the composition of output, rose at a 7.1 percent seasonally adjusted annual rate, compared with a 12.4 percent gain in the previous quarter.

Consumer prices rose at a 6.4 percent seasonally adjusted annual rate in the first quarter, down substantially from the 9.8 percent advance recorded in the previous quarter. The slowdown was mainly attributable to a mild 3.7 percent annual-rate rise in consumer prices during March, the smallest monthly advance since July 1973 when a partial price freeze was in effect. Responding to earlier declines at the wholesale level, retail food prices fell at a 6.3 percent annual rate in March. In addition, nonfood commodity prices rose at a 7.4 percent annual rate during the month, well below the 11.3 percent advance recorded in the last half of 1974. Finally, prices of consumer services increased at a 4.4 percent annual rate in March, compared with the 9.4 percent advance posted over the last six months. The moderation was due largely to a decline in mortgage interest rates.

Wholesale prices fell at a 6.8 percent seasonally adjusted annual rate in the first quarter, in sharp contrast to the 12.7 percent advance posted in the previous quarter. While the decline was centered in agricultural prices, which fell at a 33 percent annual rate during the January-March period, there was also a noticeable moderation in price increases for industrial commodities. During the first quarter, wholesale industrial prices rose at a 5 percent annual rate, well below the 7.9 percent advance that occurred in the fourth quarter of 1974. With prices of crude materials excluding food and feed declining at a 7.7 percent annual rate in the first quarter, further moderation in industrial prices appears likely. Moreover, the fact that wholesale prices of consumer finished goods rose at only a 4.9 percent annual rate in the first quarter suggests that there will be further relief at the retail level as well.

PRODUCTIVITY, WAGES, AND EMPLOYMENT

Despite the economic slump, cost pressures apparently mounted during the first quarter, as compensation per hour worked in the private economy rose at a 10.4 percent seasonally adjusted annual rate. This sizable increase, when adjusted for the slowdown in consumer prices, enabled real hourly compensation to rise modestly after two consecutive quarterly declines. Output per hour worked, which typically begins rising during the latter stages of economic contractions, edged up at a 0.6 percent annual rate in the January-March period. However, this was due to a sharp increase in farm productivity, which more than offset a further decline in productivity in the nonfarm sector. As a consequence of these changes in compensation and output per hour worked, unit labor costs rose at a 9.7 percent annual rate in the first quarter.

According to a separate survey of collective bargaining agreements covering 5,000 or more workers, agreements reached in the first quarter provided for a 13 percent annual rise in wages and benefits in the first year of the contract and a 7.5 percent gain over the life of the contract. Evidently, unions are still striving to make up for previous losses in real earnings as a result of inflation. For wages alone, first-year increases amounted to 12.5 percent while life-of-contract settlements provided for a 7.7 percent annual increase. The most lucrative settlements were negotiated in nonmanufacturing, but contract settlements in manufacturing, where unemployment has been especially severe, also were quite liberal. Settlements in the construction industry were modest, partly because of the small number of contracts that were signed during the period. Effective wages—which include gains arising from current settlements, deferred increases negotiated in earlier years, and additional gains resulting from escalator clauses—increased at a 6.1 percent annual rate during the first quarter, after rising 9.4 percent in all of 1974. Only 2 percent of the first quarter's advance was attributable to current decisions as opposed to 4.8 percent in 1974. Previous settlements accounted for another 2.4 percent, while only 1.6 percent resulted from escalator provisions.

Labor market conditions deteriorated somewhat further in April, although there was a gain in total employment. According to the household survey, the civilian labor force rose sharply by 433,000 persons in April after growing very little over the previous six months. Apparently, many workers had either dropped out of the labor force or delayed their entry because of the dismal job situation. Meanwhile, the number of persons employed rose by 237,000 in April, the first such increase since last September. This rise was less than the growth in the labor force, however, so that the seasonally adjusted unemployment rate rose by 0.2 percentage point to 8.9 percent in April. All labor force groups shared in this rise in joblessness. At 5.6 percent, the jobless rate for married men was the highest since August 1958. The nonwhite unemployment rate climbed to 14.6 percent in April, while the white jobless rate rose 0.1 percentage point to 8.1 percent.

According to the payroll survey of establishments, seasonally adjusted nonfarm payroll employment dropped slightly in April. Of course, the household and payroll surveys often diverge in a particular month because of sampling and coverage differences; however, over longer periods they tend to show comparable changes. Manufacturing employment fell by 96,000 workers in April, but the decline was much smaller than it had been in previous months. The stepped-up pace of automobile production in April led to some reduction in layoffs in this industry. Employment fell slightly in the construction and public utilities industries in April, while jobs in government, trade, and services increased.