The Business Situation

The expansion in economic activity has slowed in recent months, but inflationary pressures have remained extremely severe. In view of the persistent buildup in the backlog of unfilled orders, continued pressures on capacity, and rather widespread shortages of materials and skilled labor, much of the slackening in real growth probably reflects supply limitations. While consumer spending for durable goods and new housing moderated in the second quarter from the very high levels experienced earlier this year and in 1972, it is not possible at this time to determine whether a significant easing of consumer demand is under way. In any event, the price freeze may be temporarily boosting consumer expenditures, and further gains in business inventory and capital spending seem likely in the months ahead. During July the unemployment rate dipped to 4.7 percent, the lowest in more than three years, but both employment and the labor force were essentially unchanged from their June levels.

Price behavior remains a source of very serious concern. Over the first half of the year, both the implicit price deflator for gross national product (GNP) and the consumer and wholesale price measures climbed at the fastest rates in more than twenty years. While some improvement in the statistics as a result of the price freeze has already materialized, demand pressures remain excessive. The Phase Four controls program should serve to spread out the rise in prices as the freeze is ended, but inflation will remain a serious problem so long as aggregate demand continues overly strong.

GROSS NATIONAL PRODUCT AND RELATED DEVELOPMENTS

The market value of the nation's output of goods and services rose $28.5 billion during the second quarter to a seasonally adjusted annual rate of $1,271 billion, according to preliminary Department of Commerce statistics. Measured in current dollars, GNP climbed at a 9.5 percent seasonally adjusted annual rate, well under the pace of expansion in the first quarter. Nearly three fourths of the second-quarter advance in GNP reflected an increase in prices. After adjustment for the price rise, real GNP moved ahead at a 2.6 percent annual rate in the April-June period, the slowest advance since the 1969-70 recession. Along with the preliminary data, the Commerce Department released its annual revisions of the GNP data going back through 1970. The estimate of growth in real GNP in the first quarter of this year was revised upward to an exceptionally rapid 8.6 percent per annum. Due mainly to the strong growth in the previous quarters, the increase in real GNP over the four quarters ended in June stands at 6.2 percent (see Chart I).

To a considerable extent, the slowdown in the growth of economic activity in the second quarter may have resulted from capacity limitations and shortages of skilled labor. Many important industries—such as automobiles, rubber, paper, petroleum refining, glass, cement, aluminum, and steel—are reportedly running at, or near, capacity. Output growth has slowed most noticeably in industries known to be operating close to capacity. For example, motor vehicle production, which has been running at overtime rates, rose at only a 1 percent annual rate in the April-June quarter, after shooting up at a 26 percent rate in the first quarter. Also, iron and steel production, which has been near capacity levels for almost a year, actually declined in the past quarter. Overall industrial production expanded by a smaller amount in the second quarter than in the first and, according to the Board of Governors of the Federal Reserve System index, the growth of output slowed to less than a 4 percent rate in June.

The pace of inventory investment picked up in the second quarter, although the increase was quite modest (see Chart II). Incomplete data indicate that the annual rate of inventory accumulation on the national income accounts basis amounted to $5.3 billion in the April-June period as compared with $4.6 billion in the January-March period. Inventory spending thus contributed $0.7 billion to the growth of GNP. Larger inventory increases may well have been planned, but constraints on production and the high volume of sales may have prevented firms from realizing the desired additions to stocks. The ratio of the book value of total business inventories to sales dropped to extremely low levels in the first quarter, and hence considerable restocking of supplies was anticipated. Since the inventory-sales ratio still remains quite low by historical standards, prospects seem good for a further, sizable expansion in inventory spending in the months ahead.

The rise in final expenditures—GNP net of inventory accumulation—slowed in the second quarter. Final sales climbed $28 billion, down from the massive $46.8 billion advance of the first quarter. All the components of final spending moved higher, but most gains were relatively moderate. In particular, the increases in personal consumption and business fixed investment spending were considerably smaller than in the preceding quarter.

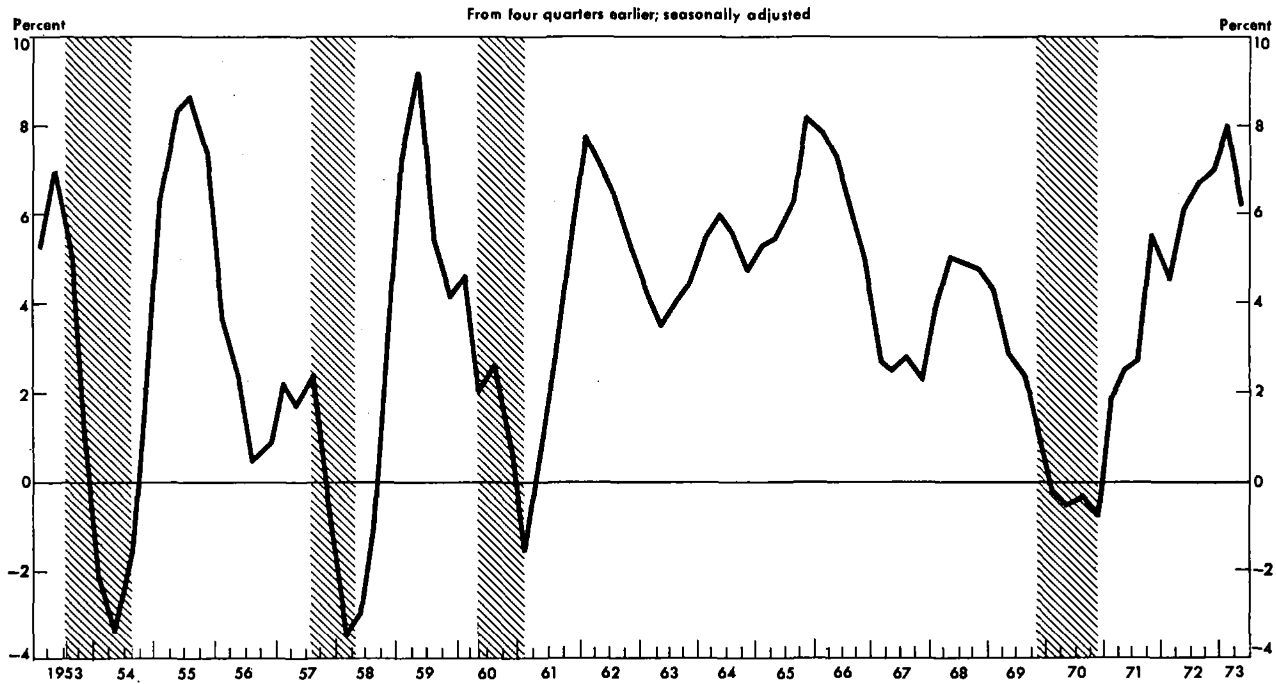
Personal consumption expenditures expanded by $15.7 billion in the second quarter, a sharp decline from the huge first-quarter advance of $26.8 billion. The increase in outlays on consumer durables shrank to $0.9 billion in the April-June interval following an enormous $9.3 billion burst in the initial quarter of the year. Indeed, after adjusting for higher prices, expenditures on consumer durables actually fell in the quarter as automobile sales and sales of other durable goods softened from their very strong first-quarter performance. The growth in spending on nondurable goods also moderated from the large increase in the previous quarter. On the other hand, the climb in outlays for services topped the gain of the first quarter.

The outlook for consumer spending in the months ahead is complicated by several factors. The price freeze, in effect on most products until August 13, could induce consumers to step up their purchases in the near term in anticipation of higher prices when the freeze ends. In July, domestic auto sales were at a healthy 10.3 million unit annual rate. On the other hand, increased uncertainty about the economic outlook may restrain consumer spending. Retail

Chart I

PERCENTAGE CHANGES IN REAL GROSS NATIONAL PRODUCT

From four quarters earlier; seasonally adjusted



Note: Shaded areas represent recession periods, according to 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.

sales remained below their March peak throughout the second quarter. Moreover, the University of Michigan's index of consumer sentiment has declined steadily since the third quarter of 1972 to reach in May its lowest level since the 1969-70 recession. According to the Michigan survey, consumers are concerned about both their personal financial circumstances and prospects for business activity in general. A more recent survey conducted by the Conference Board reported that consumers have reduced their plans to buy automobiles and homes from the high levels indicated in the spring.

In the latest revisions of the GNP data, the personal saving rate—the ratio of savings to disposable personal income—was significantly reduced for the past year, reflecting a larger rise in spending than previously reported. According to the revised estimates, the saving rate dropped sharply in the first half of 1972 and has changed little, on balance, since then. The slowdown of the growth in consumer spending in the second quarter was accompanied by a slight rise in the saving ratio to 6 percent, the rate that prevailed on average during much of the 1960's. By comparison, the saving rate stood at 5.9 percent in the first quarter of this year and at 5.8 percent in the second quarter of 1972.

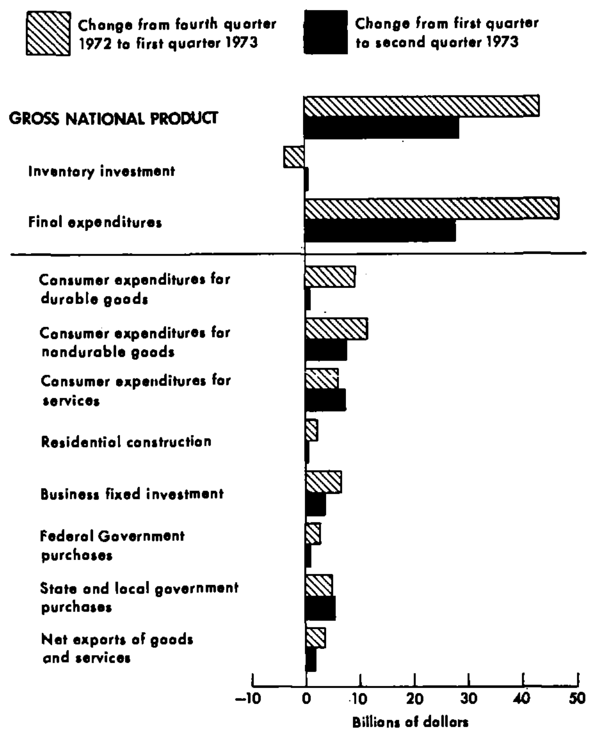
Business fixed investment grew by $3.5 billion in the second quarter, only about half the strong expansion of the preceding three-month interval. This slackening was concentrated in spending for producers' durable equipment. In particular, purchases of trucks dropped off after a very strong performance earlier in the year. Notwithstanding this moderation, the expansion of business fixed investment was at a robust 17 percent annual rate over the first half of the year. This increase falls between the 13 percent expansion expected by the Commerce Department in its May survey of plant and equipment investment plans and the 19 percent rate projected in the McGraw-Hill spring survey which was supported in a special follow-up survey. In light of the diminishing reserve of unused productive capacity and the results of the capital spending surveys, it seems likely that investment outlays will remain strong in coming months.

Residential construction spending inched up by only $0.5 billion in the second quarter, providing additional evidence that the boom in housing is over. Other measures of housing activity confirm the slackening in home building apparent in the national income accounts and presage further weakening in residential building. Housing starts fell from an average 2.4 million units at an annual rate in the first quarter to a 2.2 million rate in the second quarter. Similarly, newly issued building permits were off 12 percent, relative to the first-quarter average.

Chart II

RECENT CHANGES IN GROSS NATIONAL PRODUCT AND ITS COMPONENTS

Seasonally adjusted



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

Government purchases of goods and services contributed about $6.5 billion to the second-quarter GNP advance. Expenditures of state and local governments increased by a substantial $5.5 billion, $0.5 billion above the rise of the previous quarter. The recent rapid gains in state and local government spending undoubtedly reflect the favorable budget position of many of these governments and the receipt of funds from general revenue sharing. Federal spending moved up by a modest $1 billion in the April-June period. Defense spending accounted for only a small portion of this increase.

WAGES, COLLECTIVE BARGAINING AGREEMENTS, PRODUCTIVITY, AND EMPLOYMENT

The rate of wage gains continues moderate, on balance. During the April-June period, wage and benefit increases agreed upon in collective bargaining situations involving 5,000 or more workers remained at about the moderate pace of the first quarter. Settlements concluded in the first six months of 1973 provided for mean life-of-contract wage and benefit increases at a 6.2 percent average annual gain, compared with a 7.4 percent rate in the previous year. The latest figures represent a decline from the extremely high 1970-71 rates, when wage and benefit growth averaged 8.9 percent over the life of the contract. (These data do not include the cost-of-living adjustments contingent on movements in consumer prices.) In addition, the recent contract negotiations have been settled without disruptive strikes. During the first six months of this year the percentage of working time lost because of strikes was the smallest in nine years, even though contract negotiations involve nearly as many workers as in the peak years of 1970 and 1971. Of course, the labor calm may not persist in light of the negotiations in major industries scheduled for later this year.

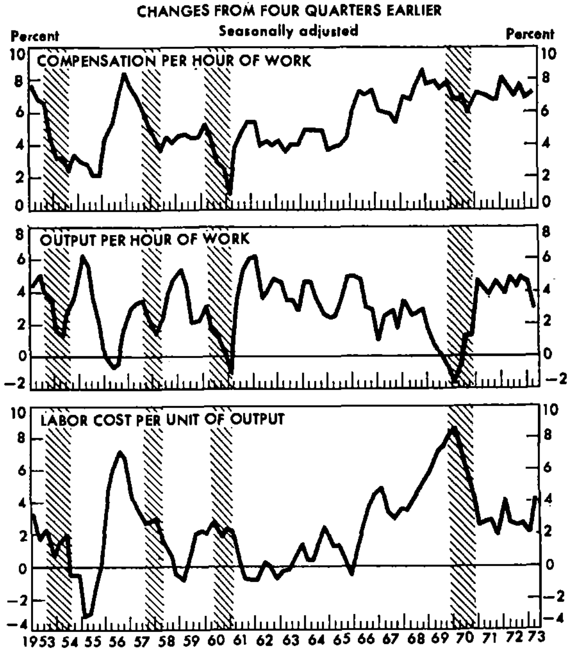
In the second quarter, compensation per hour of work in the private economy rose at a 7.2 percent seasonally adjusted annual rate, considerably smaller than the 9.4 percent expansion in the January-March period. Since the first-quarter compensation data were inflated by greater social security taxes paid by employers, the large difference between the quarterly figures exaggerates the deceleration. The second-quarter rise in compensation is the same as the gain experienced during the four quarters ended in June (see Chart III).

Chart III

LABOR COMPENSATION, PRODUCTIVITY, AND UNIT LABOR COST IN THE PRIVATE ECONOMY

CHANGES FROM FOUR QUARTERS EARLIER

Seasonally adjusted



Note: Shaded areas represent recession periods, according to the National Bureau of Economic Research chronology.

Source: United States Department of Labor, Bureau of Labor Statistics.

The hourly earnings index—which is adjusted for inter-industry employment shifts and overtime in manufacturing—is the closest available approximation of basic wage rates for the private nonfarm sector's 51 million production workers. In July, the index rose at a 4.9 percent seasonally adjusted annual rate, bringing the growth over the most recent twelve months to 6.1 percent.

Productivity, as measured by output per hour of work in the private economy, showed no growth in the second quarter after rising at a 3.9 percent annual rate in the January-March period. Excluding the farm sector, where productivity changes tend to fluctuate widely from quarter to quarter, productivity fell slightly in the second quarter, the first decline since the fourth quarter of 1970. The drop in nonfarm productivity came after six quarters of growth considerably above the long-run trend rate of increase. The abrupt halt in the increase in productivity shown in the preliminary statistics seems inconsistent with the small moderation in the expansion of industrial production. Since there was no productivity improvement to help offset the continued rise in compensation per hour of work, unit labor costs moved sharply higher at a 7.7 percent annual rate, the fastest rise since the first quarter of 1970.

The labor market changed little from June to July. According to the monthly survey of households, both the civilian labor force and employment decreased slightly in July following the exceptionally large gains recorded during the preceding month. The overall unemployment rate slipped to 4.7 percent, its lowest level in more than three years; in comparison, the rate of unemployment was 5.6 percent a year earlier. During July, the jobless rate for adult males moved down to 3 percent from 3.2 percent in June. Meantime, the unemployment rate for adult women was unchanged at 4.9 percent, and the volatile teen-age jobless rate rose from 13.3 percent to 14.4 percent.

In the separate July survey of establishments, nonfarm payroll employment generally continued at the June levels. An increase in employment in the service industries was largely counterbalanced by a decline in manufacturing employment. While the number of workers on factory payrolls declined during July, the average workweek of manufacturing production workers advanced 0.3 hours to 40.9 hours. Overtime remained at 3.8 hours per week.

PRICE DEVELOPMENTS

Prices continued to rise at unacceptably rapid rates up to the imposition of the price freeze on June 13. All of the major price measures—the implicit GNP deflator for the second quarter, the consumer price index, and the wholesale price index—gave clear signs of the severity of the inflation prior to the price freeze. While the freeze has already resulted in some improvement in the wholesale price index, it is doubtful that any abatement in underlying inflationary pressures has been achieved. The most severe price pressures have been concentrated in areas of extremely strong demand, such as food, fuel, livestock feed, and many unprocessed industrial nonferrous metals. In an effort to restrain the inflation, the Phase Four controls, scheduled for implementation on August 13, will allow only a dollar-for-dollar pass-through of cost increases in most industries. While the many special regulations covering specific industries considerably complicate the price picture, the narrow margin of idle productive resources in the economy suggests that inflationary pressures will remain strong.

According to the preliminary data, the implicit GNP price deflator surged at an extraordinary 6.8 percent seasonally adjusted annual rate in the second quarter, the fastest climb since the first quarter of 1951 when prices were affected by the Korean war. The rise in the April-June period came on the heels of the exceptionally large 6 percent rise in the initial quarter of the year. Rapid as these increases are, the fixed weight GNP price index, which is based on the composition of spending in 1967, has risen even more sharply in recent quarters. In the second quarter the fixed-weight index climbed at a 7.2 percent annual rate, and over the past year this index has advanced 5.5 percent. These figures probably give a better reading of the breadth and intensity of recent price pressures in the economy than does the implicit deflator.

At the retail level, consumer prices climbed in June at nearly a 7 percent seasonally adjusted annual rate. Over the first six months of 1973, consumer prices jumped at a 7.8 percent annual rate, the fastest rise in twenty-two years. Food prices have long been the chief culprit in the unsatisfactory consumer price situation. While the rate of increase in consumer food prices has braked from the extraordinary advance of the first quarter, these prices still moved upward at a very disturbing 11 percent annual rate in June. In the meantime, increases in the prices of nonfood commodities and services have been accelerating. The prices of gasoline, fuel oil, household durable goods, and used cars all rose sharply in June. Over the second quarter as a whole, prices of nonfood commodities climbed at a 5.3 percent annual rate by comparison with an increase in the first quarter at less than a 4 percent pace.

After skyrocketing over the first six months of the year, wholesale prices in July fell at a 17 percent annual rate, the steepest drop in twenty-five years. The first decline in the wholesale index in almost two years reflected a sharp plunge in the prices of farm products and processed foods and feeds. In turn, a drop in the price of soybeans, which have been subject to export controls, accounted for much of the decline in the agricultural commodities component. However, since the survey of wholesale prices was taken, the prices of many farm goods have climbed again, so that the improvement in the index is likely to be short-lived. The price freeze apparently has had some success in holding wholesale prices of industrial commodities steady; industrial prices rose at just a 0.7 percent annual rate in July.