The Business Situation

The economy is continuing to expand at a more moderate rate than was experienced during the period of hectic and unsustainably rapid advance in late 1972 and early 1973. Over the past two quarters, the growth of real gross national product (GNP) has averaged 3 percent at an annual rate. This is well below the 7 percent averaged from the end of 1971 through the first quarter of this year. At this point, however, it is still unclear how much of this slowing in real growth is the consequence of capacity constraints and supply bottlenecks and how much is the reflection of less exuberant demand. At present, there are many signs that pressures on capacity are very pronounced. Shortages of parts and other production difficulties helped keep new car output and sales somewhat below what they might have been in the third quarter. The recent decline in new orders for durable goods may reflect the fact that some major industries are booked to capacity. Delivery lead times for new orders are exceedingly long, and the rate of capacity utilization in the major materials industries climbed to a record in the third quarter. By October, unemployment had fallen to its lowest rate in three and one-half years.

Residential construction is one area where activity has slackened. Consumer demand may also be moderating, and there has been a sharp deterioration in "consumer confidence". The threatening energy crisis has added another element of uncertainty to the economic outlook and was responsible in part for the gloom which pervaded the stock market in early November. On the other hand, business spending on plant and equipment has been very strong and, according to the available surveys of investment intentions, should remain strong in 1974.

While interpretation of the price data has been complicated by the frequent changes in the Economic Stabilization Program, inflation clearly remains very much a problem. The GNP deflator increased at a 6.7 percent annual rate in the third quarter, about the same as over the first half of the year but about twice as fast as during 1971 and 1972. Consumer price increases moderated in September, but this slowing came on the heels of a spectacular burst in the preceding month. Total consumer prices rose at a 10 percent annual rate over the three months ended in September and 7.4 percent during the past year. Although the degree of acceleration has been less dramatic, wages are also rising rapidly. Hourly compensation in the private economy climbed at an 8.4 percent annual rate in the latest quarter and, along with slower growth in productivity, led to a substantial increase in unit labor costs.

GROSS NATIONAL PRODUCT AND RELATED DEVELOPMENTS

According to preliminary estimates from the Department of Commerce, the market value of the nation's output of goods and services (GNP) rose \$32 billion to a seasonally adjusted annual rate of \$1,304 billion during the third quarter of 1973. Measured in current dollars, GNP climbed at a 10.4 percent annual rate, somewhat above the pace recorded in the second quarter. After adjustment for changes in the price level, GNP expanded at a 3.6 percent rate in the July-September period, up from the second-quarter increase but well below the rate of expansion experienced from late 1971 through the first quarter of this year.

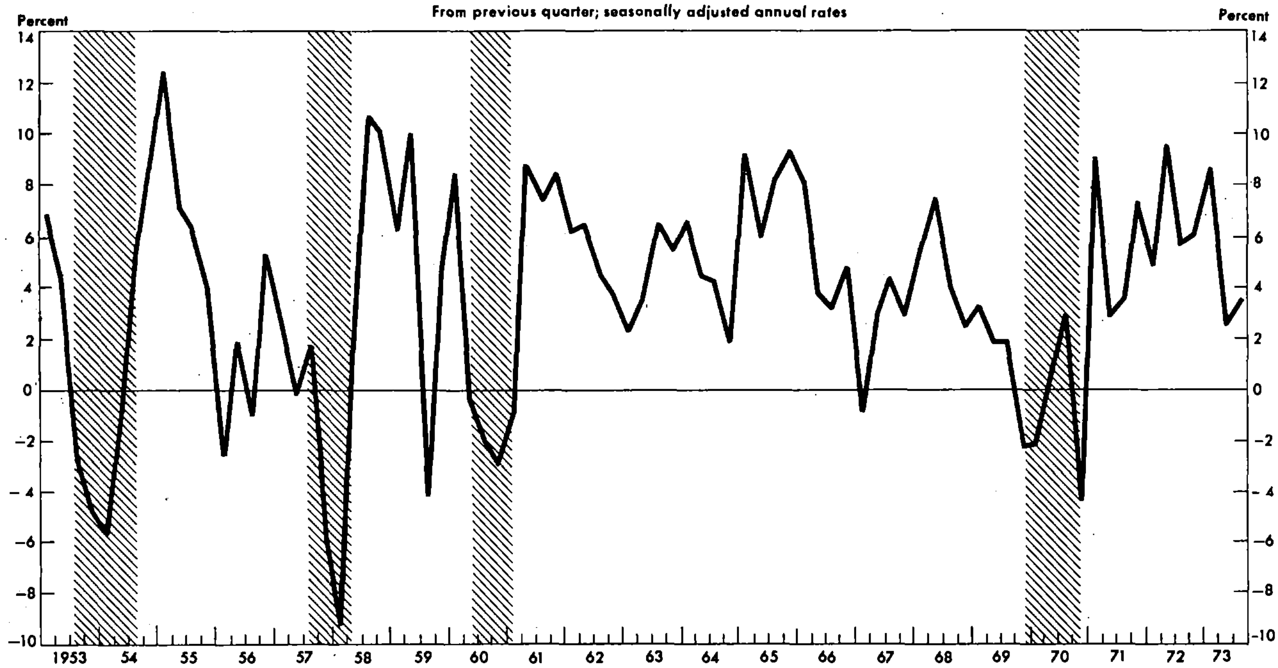
The recent slowing in the growth of real GNP may represent a return to more sustainable rates of increase and does not necessarily presage the end of the expansion and the onset of a recession. In the past, real growth has on several occasions dropped below its long-term trend of close to 4 percent in successive quarters without being followed by a recession (see Chart I). Moreover, continued high levels of unfilled orders with respect to sales volume, of capacity utilization, and of employment suggest that supply constraints are responsible, at least in part, for the moderation in growth.

The relative contribution of expenditure components to the third-quarter GNP gain differed perceptibly from the pattern of the April-June period (see Chart II). Inventory investment, which did not contribute to GNP expansion in the previous quarter, added \$4.2 billion to the third-quarter advance in GNP, while final expenditures—GNP net of inventory accumulation—rose by \$1.9 billion less than in the April-June period. Inventory accumulation reached \$8.7 billion at an annual rate in the third quarter,

Chart I

PERCENTAGE CHANGES IN REAL GROSS NATIONAL PRODUCT

From previous quarter; seasonally adjusted annual rates



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.

its highest level since the corresponding quarter of 1972 and almost twice the size of the gains registered in the first two quarters of this year. Notwithstanding this rise in inventory spending, by historical standards the ratio of inventories to sales for all business remained low in August, the latest month for which data are available, suggesting that further strengthening in this area is likely in the quarters ahead. A significant proportion of the third-quarter inventory buildup ($1.5 billion) was in the farm sector, with farmers apparently holding supplies off the market in anticipation of higher prices.

The growth of personal consumption expenditures has slowed substantially. Over the past two quarters, the average increase has amounted to $17 billion, compared with an average rise of $20 billion per quarter over the year ended this past March. When stripped of price increases, the braking emerges more clearly, since consumption expenditures grew at only a 1½ percent annual rate during the six months ended in September, after rising 8 percent in the previous four quarters.

During the third quarter, current dollar spending on consumer durables declined $0.7 billion, marking the first cutback in almost three years. Mobile home sales, which are included in consumer outlays for durable goods, accounted for much of the decline. Expenditures for passenger cars edged down $0.2 billion, after declining $0.5 billion in the previous quarter. While this decrease may reflect a change in the composition of demand toward smaller vehicles, it is probably also related to the difficulties experienced by domestic and foreign producers in supplying adequate numbers of vehicles. Sales of domestically produced cars dropped to a seasonally adjusted annual rate of 8.7 million units in October, down from the 10.1 million units averaged over the earlier months of 1973. Industry observers are unsure how much of this decline represents a weakening of demand. It is also worth noting that purchases of nonautomotive durable goods were essentially unchanged during the quarter. With sharply higher outlays for food and beverages, spending on nondurables picked up somewhat, but in real terms the annual rate of increase was little more than half the rise experienced during the four quarters ended this past

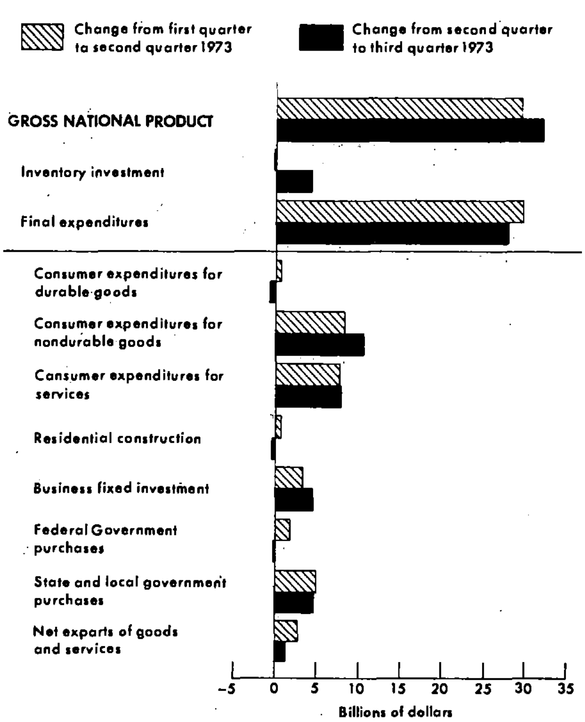
March. Expenditures for services, however, rose by a very rapid $7.9 billion, which in current dollar terms is the largest rise on record, and after adjustment for price increases represents the largest expansion since the first quarter of 1972.

The overall slowdown in the growth of consumer spending seems related to a number of developments. Shortages, particularly for automobiles, probably meant that some demands went unfilled during the third quarter. On the other hand, some weakening of consumer demand appears to have taken place during the past half year. In nominal terms, disposable personal income increased almost as briskly in the past two quarters as during the previous year, but inflation pared the second- and third-quarter real gain to an annual rate of 2 percent, which is less than a third as large as the rise over the year ended in March. As measured by the University of Michigan index, consumer optimism deteriorated sharply during the third quarter and reached a record low. This rather precipitous decline is related, in part, to apprehensions concerning inflation.

Chart II

RECENT CHANGES IN GROSS NATIONAL PRODUCT AND ITS COMPONENTS

Seasonally adjusted



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

Business fixed investment climbed by $4.6 billion in the July-September period, a greater rise than that of the second quarter but less than the expansion of the two preceding quarters. Spending on structures increased by $2.8 billion, the largest advance on record. At the same time, durable equipment expenditures rose $1.9 billion. Equipment outlays would probably have been higher, but the output of automotive equipment—such as trucks—was hampered by parts shortages and other production problems during the quarter. Over the first three quarters of this year, business fixed investment rose at a 15.7 percent seasonally adjusted annual rate, compared with the 15.1 percent rise recorded in 1972.

The sizable backlog of unfilled orders and the high level of capacity utilization in the economy suggest a need for continued expansion in capacity. Basic materials industries, in particular, are operating very close to capacity levels. According to the Federal Reserve Board, the major materials producing industries—which include such key areas as primary metals, paper, petroleum refining, and textiles—were operating at a record 96.3 percent of their estimated capacity during the third quarter (see Chart III). In perspective, current operating rates in the materials industries substantially exceed those experienced during previous periods when capacity pressures were quite pronounced, e.g., during the Korean war, the mid-1950's, and the late 1960's. Recent survey data indicate substantial demand for fixed investment goods in the coming year. The latest Lionel D. Edie & Company Inc. survey of intended plant and equipment spending in 1974 points to a 12 percent increase above the 1973 level, while the Rinfret-Boston fall survey foresees a 15.3 percent advance.

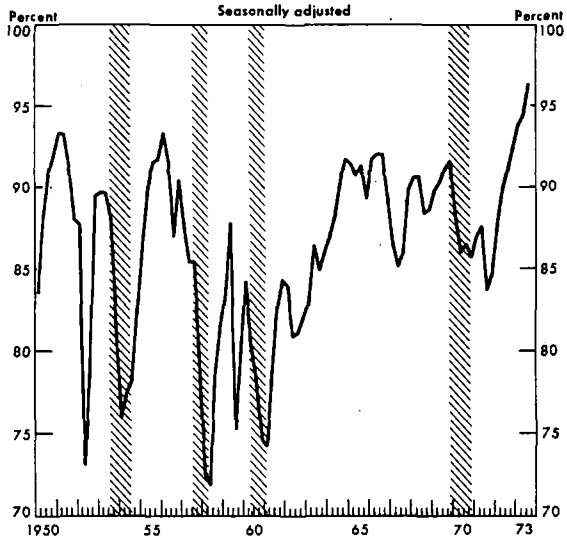
Residential construction spending fell by $0.3 billion in the third quarter, the first decline since the second quarter of 1970. Other measures of housing activity confirm the slack in home building. Over the third quarter, housing starts dropped by 17.2 percent to 1.76 million units (annual rate) in September. This figure is 27 percent below the rate of starts posted a year earlier. Similarly, building permits skidded 21 percent in the third quarter to a seasonally adjusted annual rate of 1.6 million in September. Moreover, the ratio of unsold new homes to monthly sales of new one-family homes increased in August, the latest month for which data are available, to an all-time high of 10.1 months of sales at the August rate.

Government purchases of goods and services rose at a $4.6 billion rate, the slowest pace in the past four quar-

Chart III

CAPACITY UTILIZATION INDEX FOR MAJOR MATERIALS INDUSTRIES

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: Board of Governors of the Federal Reserve System.

ters. Spending at the state and local levels rose $4.8 billion, down somewhat from the $5.1 billion gain averaged in the preceding year. The fall in outlays at the Federal level was accounted for by a decrease in defense spending.

PRICE DEVELOPMENTS

There was little indication of a significant cooling of inflation in the third quarter. However, because of changes in the Economic Stabilization Program introduced during the period, it is difficult to separate the transitory from the more fundamental phenomena. The period began with a freeze in effect on prices of almost all items. This was lifted for most foods on July 18, for most nonfood items on August 12, and for beef on September 10. Subject to the profit margin and notification requirements, current Phase Four guidelines allow prices to go up only as fast as the dollar increases in costs. Throughout the quarter, wages were permitted to rise in accord with the ground rules developed earlier under Phases Two and Three.

According to preliminary data, the implicit GNP price deflator rose at a 6.7 percent annual rate in the third quarter, the same as its increase over the first half of the year. The severity of the acceleration in the rate of inflation can be seen from the fact that during both 1971 and 1972 the GNP deflator rose only about 3½ percent. Agricultural prices continued to have a marked impact on the overall inflation rate during the third quarter. The deflator for GNP originating in the farm sector rose at the astronomical annual rate of 107 percent, faster even than the 51 percent and 76 percent climbs recorded, respectively, during the first two quarters of the year. In the private nonfarm business sector, prices increased at a 4.3 percent rate. While this advance appears quite modest alongside the farm deflator, it is little changed from the 4.8 percent rise recorded over the first half of the year and, perhaps even more disturbing, is well above the 2½ percent averaged during each of the two preceding years.

Consumer prices rose at a 3.8 percent seasonally adjusted annual rate in September, down considerably from the very rapid August pace of about 23 percent. Food prices, which soared at almost a 74 percent annual rate in August, declined 1.6 percent in September and were largely responsible for this slowing. Given the timing distortions introduced by the price freeze and Phase Four, a look at a somewhat longer time span than a single month is useful. During the third quarter, total consumer prices moved up at an annual rate of 10 percent, compared with an advance of nearly 8 percent over the first half of the year. Food prices increased at a 26 percent pace during the quarter, somewhat more rapidly than over the first half of the year.

In the three months ended in September, seasonally adjusted prices of consumer nonfood commodities rose 2.6 percent at an annual rate, more slowly than the 4.6 percent rate of advance in the first half of the year. During September, such prices increased by a mere 1 percent after rising almost 6 percent in the previous month. However, since the Economic Stabilization Program may have affected normal seasonal patterns, it is worth noting that, unadjusted for seasonal variation, nonfood commodities prices rose at a 4.8 percent annual rate in September, up from 2.9 percent the month before and from the 1.9 percent decline recorded in July under the influence of the freeze. Increases in the price of services, which are not adjusted for seasonal variation, accelerated sharply to about a 7 percent annual rate in the third quarter from a 4 percent rise in the first half of the year and 3½ percent in 1972. While a major source of rising services prices in recent months has been higher home-mortgage interest costs, prices of other items have also increased rapidly.

Wholesale prices fell in October for the second consecutive month. The decline, at a 3.6 percent seasonally adjusted annual rate, stemmed from a sharp drop in agricultural prices which more than offset a substantial increase in prices of industrial commodities. Prices of farm products, processed foods, and feeds fell nearly 40 percent at an annual rate in October. Nonetheless, wholesale farm prices still stand 28 percent higher than six months ago and 35 percent above the level of a year earlier. During October, prices of industrial commodities jumped 13.7 percent (annual rate), the largest monthly gain since May. Some of this advance may be attributed to a bunching of price increases, since under Phase Four rules large firms could not raise prices until mid-September. In any event, a sizable proportion of the overall advance in industrial commodities prices was accounted for by rising fuel prices, and prices of textile products and apparel, steel and iron, and nonferrous metals also rose rapidly. Over the year ended in October, wholesale prices of industrial commodities climbed 9.1 percent, up substantially from the 3.3 percent increase of the previous year.

WAGES, PRODUCTIVITY, AND EMPLOYMENT

Recent data indicate that the pace of wage increases has undergone a noticeable acceleration. In the third quarter, compensation per hour of work in the private economy rose at a seasonally adjusted annual rate of 8.4 percent, bringing the rise over the past year to 8 percent. In comparison, compensation climbed 6.2 percent over the year ended in the third quarter of 1972. However, after adjusting for the very rapid climb in the consumer price index, real private compensation declined in both the second and third quarters. The evidence that wages have not kept up with inflation during much of 1973 points to increased pressures on wage levels as workers try to maintain living standards.

According to data gathered by the Labor Department on major collective bargaining settlements, contracts negotiated during the first nine months of the year called, on average, for first-year wage rate increases of 6 percent and life-of-contract gains of 5.5 percent. However, first-year increases for wages and benefits combined came to a substantially larger 7.6 percent. Because these Labor Department data do not include those payments made under "escalator clause" provisions contingent on movements in the consumer price index, they understate the growth of compensation that will eventually emerge under many of these contracts. At present, about 40 percent of the more than ten million workers under major collective bargaining agreements (those covering 1,000 or more workers) have cost-of-living escalator clauses in their contracts.

Productivity, as measured by output per hour of work in the private economy, rose at an annual rate of 1.4 percent in the most recent quarter, following a small decline of 0.3 percent in the April-June period. In comparison, productivity increased more than 5 percent over the year ended this past March and at an annual rate of close to 3 percent during the past two decades. In the short run, productivity growth typically surges during the early stages of a cyclical recovery, as it did starting in 1972 and continuing through early 1973, and then begins to taper off. During the first three quarters of 1973, manufacturing productivity rose at a fairly rapid 4.8 percent annual rate, but even this increase represents a marked deceleration from the 7.3 percent advance in 1972. The recent slowing has undoubtedly been influenced by the fact that important sectors of the economy are pressing against capacity, making further output increases difficult to obtain. As a consequence of the combined changes in hourly compensation and productivity, private sector unit labor costs climbed 6.6 percent (annual rate) in the third quarter, after soaring 7.7 percent in the previous period. Over the year ended in the first quarter, unit labor costs increased by 2.1 percent. Given the near-term outlook for relatively slow productivity growth, only a considerable reduction in the rate of compensation increase could bring about a substantial lessening in the pressures on prices arising from labor costs.

Overall, the data gathered in October indicate continued firm labor market conditions. According to the household survey, seasonally adjusted employment jumped by a very large 570,000 persons, following an even bigger September climb. On a month-to-month basis, the household survey tends to give somewhat volatile readings of employment and labor force changes. Monthly increases during the past half year, however, have averaged a very substantial 300,000. The growth of the labor force in October, while strong, was smaller than that of employment. Thus, the unemployment rate, which had been essentially unchanged at 4.8 percent since June, fell to 4.5 percent in October, its lowest level in three and one-half years.

In the separate October survey of nonfarm establishments, seasonally adjusted employment also registered a large gain. Contributing strongly to the overall advance of 300,000 was the 100,000 rise in manufacturing employment, which had shown very little change between June and September. Over the past half year, manufacturing employment has, on average, increased by 40,000 per month, less than half as fast as in the preceding six months. Although October employment was up, both the average workweek and overtime hours for manufacturing production workers retreated toward their August levels and were well below the peaks reached earlier this year.