The Business Situation

Economic activity was sluggish in the second quarter, and uncertainties over the possible implications of inflation, high interest rates, and liquidity problems remain. Real gross national product (GNP) declined at a 1.2 percent seasonally adjusted annual rate, following the sharp 7 percent decline registered in the first quarter. After allowing for the effect of higher prices, disposable income declined further in the second quarter but real personal consumption expenditures increased slightly, led by the rebound in spending on services and durable goods. At the same time, however, consumer confidence apparently remained weak and purchases of nondurables slowed. Plagued by tight mortgage markets and high interest rates, real spending on new housing continued to decline, but at a significantly slower rate than in the previous six months. In constant-dollar terms, business fixed investment was roughly unchanged in the April-June period. However, the backlog of unfilled orders of durable goods manufacturers grew substantially. One of the most important factors retarding real growth in the second quarter as relates to GNP accounting was the oil-related deterioration of net exports. In July, the labor market was essentially unchanged, although the unemployment rate edged up to 5.3 percent from the 5.2 percent rate of the previous two months.

Inflation continued at a dismaying rate in the second quarter, although the rate of increase slowed somewhat. According to preliminary Commerce Department estimates, the implicit GNP price deflator surged at an 8.8 percent annual rate in the second quarter, following the 12.3 percent advance of the first quarter of the year. The rate of increase in the fixed-weight price index—which, unlike the implicit deflator, is unaffected by changes in the composition of output—also slowed, but nevertheless the fixed-weight index climbed at an 11.2 percent annual rate in the second quarter, compared with a first-quarter advance of 12.7 percent. Over the past four quarters, the implicit deflator has increased 9.5 percent, the highest rate of increase in over twenty-five years. With at least part of this price explosion attributable to the dismantling of price controls, there is hope that the rate of inflation may moderate in coming months. However, much of the most recent slowing in the rate of increase has resulted from declines in prices of agricultural commodities—declines that now may be reversed as a result of reduced forecasts of future crop harvests. Furthermore, cost pressures on prices are not likely to ease in the near term in view of the recent huge expansion in the prices of wholesale industrial commodities and the strong demand for higher wages as workers attempt to regain their loss in purchasing power.

GROSS NATIONAL PRODUCT AND RELATED DEVELOPMENTS

Preliminary data released by the Commerce Department indicate that, measured in current dollars, the market value of the nation's output of goods and services rose at a 7.5 percent seasonally adjusted annual rate in the second quarter. After adjustment for price increases, however, real GNP declined slightly, falling at a 1.2 percent annual rate in the April-June period. At this time, the Commerce Department released its annual bench-mark revisions of GNP data going back to 1971. According to revised estimates, growth in the last quarter of 1973 was somewhat stronger than in the second or third quarters of that year, whereas earlier data had indicated some weakening. In addition, the decline in real GNP in the first quarter of this year is now estimated at a 7 percent rate (see Chart I), somewhat more than was first reported.

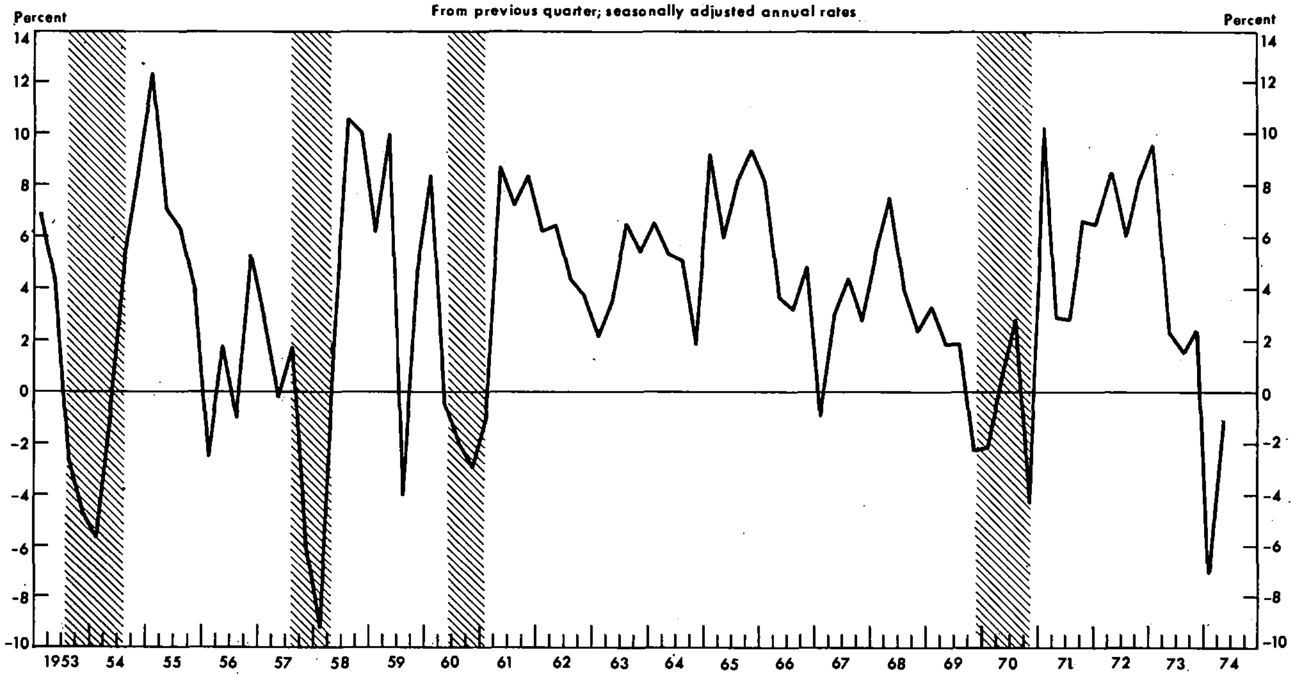
According to the preliminary estimates, business inventories rose \$15.1 billion in the second quarter, slightly less than the \$16.9 billion increase registered in the first three months of 1974. This slight decline in the rate of inventory accumulation followed a much sharper drop-off in the preceding quarter (see Chart II). For the last half of 1973 and the first quarter of 1974, Commerce Department revised estimates, which have on average doubled the original estimates of inventory spending, indicate that, measured in current dollars, inventory accumulation amounted to an average of \$19.2 billion at an annual rate over these three quarters. Although a small part of the most recent buildup has been in farm inventories, the bulk of the accumulation has been in stocks of nonfarm nondurable goods. The rate of increase in nondurable goods inventories doubled in the second quarter, rising to $16.5 billion at a seasonally adjusted annual rate from $8.2 billion in the first quarter. On the other hand, durable goods inventories fell $1.4 billion in the second quarter following an $8.7 billion dollar increase in the first quarter.

The growth of final expenditures—GNP net of inventory accumulation—remained essentially steady in the second quarter, as outlays climbed at a $26.5 billion rate compared with a $26.8 billion gain in the first quarter. After allowing for the impact of inflation, real final expenditures declined $1 billion in the April-June interval. Nevertheless, this was an improvement over the declines of $5.8 billion and $7 billion during the previous two quarters.

Personal consumption expenditures in current-dollar terms increased by $26.2 billion in the April-June period, well above the $16.7 billion increase posted in the first quarter and the $7.6 billion rise in the final quarter of 1973. Following two quarters of decline, real consumer spending registered its largest advance in over a year in the second quarter, paced by a rise in durable goods purchases. The outlook for consumer spending, however, continues to be complicated by the erosion of consumer confidence and purchasing power by inflation. The latest reading of the University of Michigan's index of consumer sentiment suggests little improvement in consumer confidence, although the index did edge up from the all-time low reached in February during the worst of the oil embargo. This survey indicated that an increasing number of consumers had become concerned over the pervasiveness of inflation.

Reversing the $0.4 billion decline in purchases of durables in the first quarter, consumer spending on durables increased $6.3 billion in the second quarter. After balking at purchasing automobiles in the January-March quarter, consumers renewed their purchases of autos, which accounted for more than one third of the increase in durables purchases. New automobile sales have gradually edged up from the 7.5 million units (seasonally adjusted annual rate) averaged in the first three months of the year to 7.9 million units in the second quarter, with 8 million units sold in

Chart I
PERCENTAGE CHANGES IN REAL GROSS NATIONAL PRODUCT
From previous quarter; seasonally adjusted annual rates

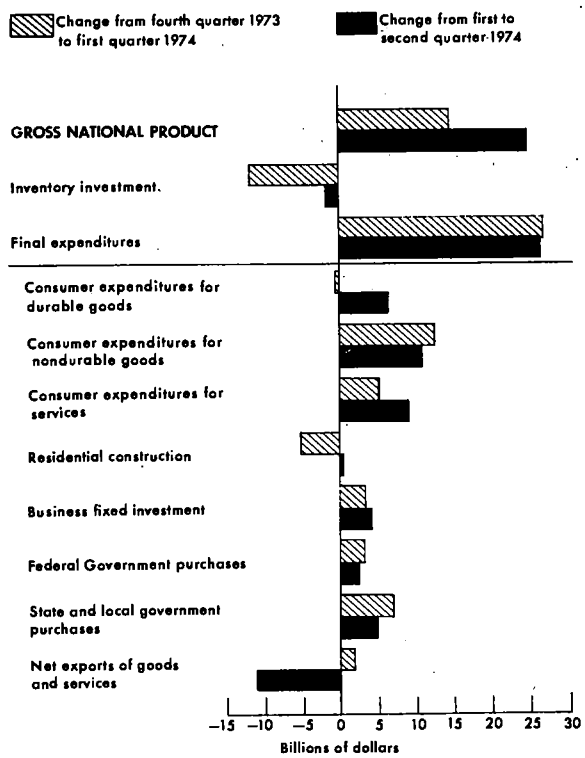


Note: Shaded areas represent recession periods, indicated by the National Bureau of Economic Research chronology. The dates of the 1969-70 recession are tentative.
Source: United States Department of Commerce, Bureau of Economic Analysis.

Chart II

RECENT CHANGES IN GROSS NATIONAL PRODUCT AND ITS COMPONENTS

Seasonally adjusted



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

June. While part of the increase in automobile sales reflects the improved availability of gasoline, sales may also have been bolstered in the second quarter by expectations of still higher auto prices in the future. The latest Conference Board survey of consumers indicated a pickup in automobile buying plans.

The growth in consumer purchases of nondurable goods slowed in current-dollar terms in the second quarter, rising by $10.8 billion following a $12.3 billion increase in the first quarter. The increase in spending on food and beverages, clothing, and shoes all were smaller than in the January-March interval. After adjustment for price increases, real nondurables expenditures declined slightly in the second quarter.

The decline in the rate of personal saving out of disposable income accelerated in the second quarter. After climbing almost continuously from mid-1972, the saving rate dropped from an exceptionally high 9.5 percent in the fourth quarter of 1973 to 8.9 percent in the first quarter and to 7.6 percent in the second quarter. It appears that consumers are attempting to maintain their consumption levels despite a continuing decline in real disposable income. Real disposable income fell in the second quarter, but the decline was less than that posted in the first three months of the year.

Business fixed investment rose $4 billion in nominal terms in the second quarter, only modestly above the upward revised $3.3 billion gain recorded over the previous three months. While this sector has been counted on to provide a good portion of the upward thrust to the economy in 1974, some firms may be delaying or reducing capital spending projects in light of financial market conditions. Most notably, some public utility offerings have faced relatively poor receptions in the bond market and, as a result, this industry has pared planned capital expenditures. The latest Department of Commerce survey of planned expenditures indicated a 12.2 percent rise in outlays in 1974; however, since these outlays are in nominal terms, they reflect the rapid inflation rate and therefore overstate the level of real business spending. On the other hand, the persistent rise in the backlog of unfilled orders of durable goods manufacturers continues to suggest that gains in capital spending may be in the offing.

After declining for three consecutive quarters, residential construction spending rose modestly in nominal terms in the second quarter of 1974. Outlays increased by a slight $0.3 billion, a considerable improvement over the $5.2 billion decline in the first quarter of this year. As a result of the decline of its relative importance, residential construction outlays now account for only 3.1 percent of real GNP, the lowest percentage since 1970. Moreover, caught in the web of high mortgage rates and unavailability of mortgage money, the outlook for residential construction remains dim. The 8.1 percent annual rate increase in housing starts in June still leaves starts one-fourth below their level of a year ago. Multifamily starts have been particularly hard hit and now stand at 43 percent below the level of such starts a year ago. Part of this decline may be because of adverse publicity concerning condominium apartments and the recently announced Government investigation of possible unfair or deceptive industry practices. Another factor depressing multifamily starts has been the rise in the rental vacancy rate to 6.3 percent, the highest level since 1967. In contrast to the jump in starts, permits for new construction were unchanged in June and remain depressed compared with a year ago.

Federal Government purchases of goods and services rose by $2.4 billion in the second quarter, primarily as a result of an increase in nondefense expenditures. Defense spending was virtually unchanged, as it rose only $0.3 billion. State and local government outlays jointly climbed $4.8 billion, a somewhat smaller gain than in the previous quarter.

Largely reflecting the impact of the oil situation, the value of net exports during the second quarter dropped to $0.2 billion, $11.1 billion below the first-quarter level. The decline in net exports was in part a consequence of the post-embargo rise in the importation of higher priced oil. Also important was the decline in the receipts of American oil companies on their investments abroad as a result of the increased participation of the Saudi Arabian government in the Arabian American Oil Company. Such receipts are included as a plus element in the net export figures, and when they decline their effect is to reduce this component.

PRICE DEVELOPMENTS

Serious inflation persisted in the second quarter. The Commerce Department estimates that the implicit GNP price deflator climbed at an 8.8 percent annual rate in the April-June period, following an upward revised 12.3 percent rise in the first quarter of 1974. Over the four quarters ended in June, the deflator increased at a 9.5 percent annual rate, the highest rate of increase recorded in over twenty-five years. Since changes in the implicit deflator reflect shifts in the composition of spending as well as price changes, the Commerce Department also calculates a fixed-weight price index based on an unchanging composition of spending. In the second quarter, the fixed-weight GNP price index, which is based on the composition of 1967 spending, rose at an 11.2 percent annual rate, slightly less than the increase of 12.7 percent recorded in the first quarter.

Consumer prices continued to increase at a very rapid rate in June, rising at an 11.5 percent seasonally adjusted annual rate. Over the twelve months ended in June, consumer prices spurted 11.1 percent, the largest increase in twenty-seven years. The broadly based June increase underscores the degree to which inflation has spread throughout the economy. While there was a marked slowdown in the increase in the prices of food and consumer power and fuel, large price increases were recorded for medical services, new and used automobiles, and household durables. Responding to some extent to the recent reductions of food prices at the wholesale level, retail food prices rose at a 3.8 percent annual rate in June, well below the 15.7 percent increase averaged over the previous twelve months. Prices of consumer power and fuel increased at a 14.9 percent annual rate in June, a substantially slower advance than the explosive 40.2 percent rise averaged over the previous six months. At least part of the bulge in prices of nonfood items in June is attributable to price increases instituted following the termination of the price controls program on May 1. Hence, current advances are to some extent only reflecting increases that were postponed by controls, and there is some hope that price gains may moderate in the future. On the other hand, cost pressures are not likely to ease in the near term in light of the recent upsurge in wage settlements.

Wholesale prices rose at a seasonally adjusted annual rate of 5.7 percent in June, well below the 14.4 percent annual rate advance averaged over the previous three months. This slowing was the result of the further fall in wholesale prices of farm products and processed foods. In posting their fourth consecutive decline, wholesale agricultural prices fell at an annual rate of 47.6 percent. It appears, however, that these declines may give way to increases in the near term. Forecasts of future crop harvests in the Midwest have been reduced, as unfavorable climatic conditions, first rain and then drought, have held down production. As a result, prices of agricultural commodities are rising once again. Continuing to reflect the end of the price controls and higher material costs, prices of wholesale industrial commodities rose at a 26.9 percent rate in June, compared with the 33.6 percent rate of increase averaged over the previous three months.

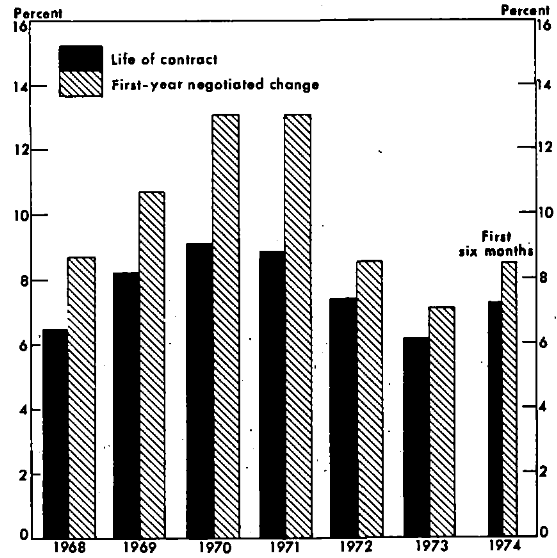
WAGES, PRODUCTIVITY, COLLECTIVE BARGAINING, AND EMPLOYMENT

Cost pressures continued strong in the second quarter as productivity remained relatively unchanged and as labor, in the face of continuing inflation and the end of wage controls, pressed for higher wage and benefit gains. Compensation per hour of work in the private sector rose at a 13.9 percent seasonally adjusted annual rate in the second quarter, the highest rate of increase in over twenty years and well above the 6.6 percent increase averaged over the previous four quarters. However, much of the second-quarter increase was attributable to a decline in hours worked in farming. In the nonfarm private sector, compensation rose at a 10.2 percent annual rate, compared with a rise of 8.5 percent in the first quarter. This advance resulted from an increase in hourly earnings and fringe benefits relative to hours of work.

As measured by real output per hour of work, second-quarter productivity in the private economy increased slightly at a 0.7 percent seasonally adjusted annual rate. This

Chart III

WAGE AND BENEFIT CHANGES NEGOTIATED IN MAJOR COLLECTIVE BARGAINING AGREEMENTS



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

increase was primarily the result of the precipitous decline in hours worked in the farm sector. It appears that the first-quarter farm hours worked were inflated as farmers rushed to bring additional land under cultivation but, with this accomplished, farm employment and hours have now fallen to levels comparable to a year ago. Excluding the variable farm sector, productivity in the private economy declined 2.8 percent. With productivity failing to record any significant rise and compensation rising sharply, unit labor costs during the second quarter rose at a 13.5 percent annual rate.

The recent declines in real wages have caused an upsurge in union demands and strike activity. The number of man-days lost because of strikes has jumped, with the second-quarter average the highest in over three years. During the past six months, first-year wage and benefit gains in collective bargaining settlements covering 5,000 or more workers aggregated 8.5 percent, a marked increase from last year's average first-year gain of 7.1 percent but well below the explosive advances recorded in early 1970 and 1971 (see Chart III). Over the life of the contract, wages and benefits rose 7.2 percent in the first half of 1974, rebounding from the six-year low of 6.1 percent recorded last year. Thus, although front loading—that is, providing a disproportionate share of the total increase in the first year of the contract—is on the upswing, the differential of first-year gains over life-of-contract advances has not approached the differential reached in 1970 and 1971 when labor last attempted to make up for lost purchasing power. Instead, it appears that a number of unions are focusing on protecting real wage gains by negotiating or liberalizing cost-of-living escalator clauses. In fact, over 10 percent of the collective bargaining settlements reached thus far in 1974 have adopted escalator provisions. Approximately 45 percent of all workers under major bargaining units are now covered by cost-of-living escalators. As a result of the growing importance of these escalators, the Bureau of Labor Statistics has initiated a new statistical series that includes the gains in cost-of-living escalators in contracts of 1,000 or more workers. These data indicate that first-year wages negotiated in the second quarter rose 10 percent, the highest quarterly advance in the six-quarter history of the new series. The escalator adjustments accounted for only 0.8 percentage point of this advance.

According to the monthly survey of households, conditions in the labor market changed little from June to July. As the growth in the civilian labor force outpaced the rise in employment, the unemployment rate edged up to 5.3 percent from the rate of 5.2 percent sustained over May and June. During July, the unemployment rate for most major labor force groups was unchanged, including the closely watched rate for married men that held at 2.6 percent. Among the labor force groups registering increases in jobless rates were white collar workers, adult women, nonwhites, and teen-agers. The 0.2 percentage point increase in the jobless rate for white collar workers increased their level of unemployment to 3.3 percent in July. The unemployment rate for adult women edged up 0.1 percentage point in July to 5.2 percent, and the volatile teen-age jobless rate rose from 15.6 percent to 16.2 percent. The nonwhite unemployment rate rose to 9.4 percent from 8.8 percent, compared with the 9.2 percent rate averaged over the first six months of 1974.

The July payroll survey of establishments diverged from the household survey, as seasonally adjusted nonfarm payroll employment declined 122,000, led by declines in employment in the construction and manufacturing industries. The two surveys often differ in a particular month because of sampling and coverage differences; however, over longer periods of time they tend to show comparable changes. While the number of production workers on factory payrolls declined, the average workweek in manufacturing rose 0.2 hours in July to 40.3 hours, despite a 0.1-hour drop in overtime. In the private nonfarm sector as a whole, the average workweek increased by 0.2 hours to 36.9 hours.