The Business Situation

Economic activity in the nation contracted sharply in the fourth quarter of 1974, and the decline apparently continued in the opening weeks of the new year. Real gross national product (GNP) declined at a 9.1 percent annual rate, falling to a level about 5 percent below the peak recorded during the last quarter of 1973. At the same time, industrial production, which had earlier been holding up, dropped at a 12.1 percent annual rate in the fourth quarter. While much of the decline in industrial production is attributable to the large reductions in automotive output, the decrease in manufacturing activity was widespread and extended beyond the automotive sector. The deterioration in economic activity was reflected in a marked worsening in labor market conditions. The unemployment rate has registered a steep rise in recent months reaching 8.2 percent in January, with all major labor-force groups showing increases.

As outlined in his recent State of the Union message to the Congress, President Ford's proposed fiscal policy measures are aimed both at stimulating the economy and at increasing the nation's self-sufficiency in energy sources. On the one hand, to stimulate the economy, the President proposed a partial rebate of 1974 personal tax payments and a one-year increase in the investment tax credit. If adopted, these two measures would return about $16 billion to the private economy. On the other hand, higher taxes on petroleum and natural gas products were proposed as part of a program to reduce energy consumption as well as to boost domestic production. Toward these ends, the President proposed import duties on crude oil and refined petroleum products, an excise tax of $2 per barrel on domestic crude oil and an equivalent tax on natural gas, the decontrol of domestic oil prices, and a windfall profits tax on oil producers. However, to prevent the measures from being deflationary, the proceeds from these taxes are to be returned to the economy through several channels: changes in the personal income tax schedule, a cut in the corporate profits tax rate to 42 percent, cash payments to low-income persons to compensate them for higher energy costs, and revenue-sharing payments to state and local governments.

Inflation has slowed markedly at the wholesale level in recent months. In the fourth quarter, increases in wholesale industrial prices slowed to a 7.9 percent annual rate, a substantial decline from the 26 percent recorded in the previous quarter. Prices at the retail level have shown only a modest deceleration in recent months. Thus, the consumer price index increased at an annual rate of 9.8 percent during the fourth quarter, bringing its total climb for the year to 12.2 percent. In December, however, reflecting special pre-Christmas sales at many stores, the consumer price index rose at only a 7.9 percent rate, the slowest advance in many months.

GROSS NATIONAL PRODUCT AND RELATED DEVELOPMENTS

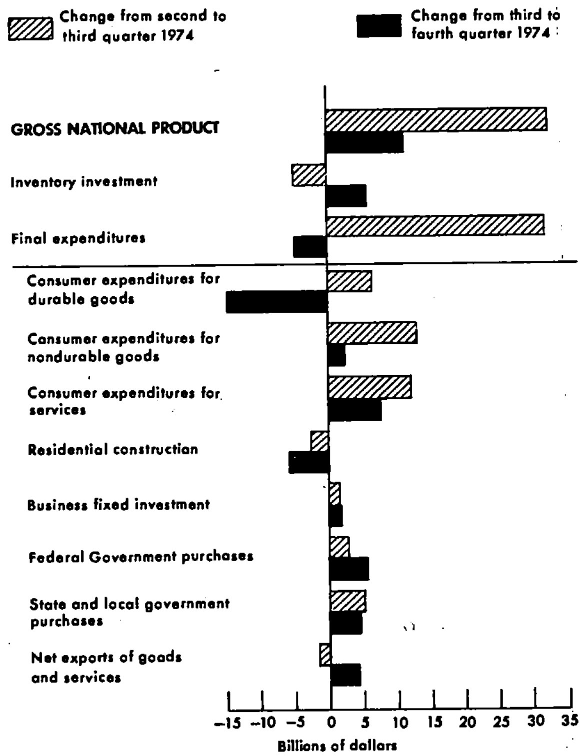
According to preliminary Department of Commerce figures, the market value of the nation's output of goods and services increased by $11.7 billion during the fourth quarter of 1974 (see Chart I) to a seasonally adjusted annual rate of $1,428 billion. However, the observed expansion was attributable entirely to price inflation and, after correction for price change, real GNP in 1958 prices declined sharply at an annual rate of 9.1 percent (see Chart II). As a result, the real value of the nation's output at the end of 1974 was 5 percent below the peak attained at the end of 1973. The hardest hit sectors have been residential construction down 32 percent, consumer spending on durable goods off 12.6 percent, and business fixed investment down 7 percent. Other components have shown varying degrees of weakness.

Industrial production fell at a 12.1 percent annual rate during the fourth quarter (see Chart II). During the two previous quarters, it had recovered somewhat following its sharp decline during the oil embargo and, by September, industrial production was only 1.5 percent below its high of November 1973. However, starting in September, output was severely reduced in several sectors of the economy. Automobiles and related industries were hit the hardest, with the output of automobiles and parts falling back by 10.6 percent and iron and steel down by 3.3 per-

Chart I

RECENT CHANGES IN GROSS NATIONAL PRODUCT AND ITS COMPONENTS

Seasonally adjusted



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

cent. However, the production of nondurable goods also fell by 3.4 percent and, reflecting some influence of the coal strike, output in mining and utilities was off by 1.7 percent. Hence, businesses used their capacity much less intensively than they had in the recent past. The index of industrial capacity utilization fell to 80.6 percent during the fourth quarter, compared with 88.5 percent during the third quarter and 92.3 percent at the end of 1973.

Although production was cut back substantially, the real value of business sales plunged at an even faster rate. As a consequence, businesses accumulated inventories—no doubt against their wishes, in light of sales experience—at a noticeably faster rate during the fourth quarter than they had earlier in the year. The real value of inventory investment was $9.1 billion, compared with an average of $7.9 billion over the first three quarters. Automobile inventories alone accounted for $4.5 billion of the advance, and at the end of 1974 automobile dealers held inventories equal to 94.8 days of sales, compared with only 68.5 days at the end of 1973. This change in auto stocks also accounts, in part, for the fact that the average level of all business inventories measured in constant dollars rose to 32.8 percent of real business sales measured at an annual rate, up from 30.3 percent at the end of 1973 (see Chart III).

Faced with substantial idle capacity, businesses have evidently begun to pare their expenditures on new capital goods. Business fixed investment measured at current market prices increased by only $1.8 billion during the fourth quarter (see Chart I), compared with an average increase of $3 billion during the first three quarters of the year. All of the increase was in structures where investment expanded by $3.3 billion. Investment in equipment actually declined by $1.5 billion even before adjustment for price changes. Correcting for inflation, business fixed investment fell 5.1 percent to $89.3 billion in 1958 prices, with outlays for structures rising $0.8 billion and expenditures on equipment declining by $5.6 billion. Moreover, the general weakening of economic conditions appears to be having a negative impact on the investment plans of business. The most recent Commerce Department survey of planned investment spending for 1975 indicates that businesses plan to spend only about 4.6 percent more on plant and equipment in 1975 than they did in 1974. These results are substantially lower than those of a September survey by McGraw-Hill, which projected a 12 percent jump in fixed investment expenditures. The McGraw-Hill survey also found that businessmen anticipated that capital goods prices would rise by approximately 12 percent during 1975. Therefore, as of September, planned real investment for 1975 was about the same as for 1974. However, if the price expectations reported by McGraw-Hill in September were still held in December, the findings of the recent Commerce survey would indicate that firms now plan a sizable net reduction in real investment during 1975.

Consumers' real disposable income continued to deteriorate during the fourth quarter, falling by 4.4 percent at an annual rate to $596.2 billion. The declining purchasing power was at least partly responsible for the sharp falloff in the volume of household consumption expenditures in real terms, which declined at an 11.9 percent seasonally adjusted annual rate—the largest quarterly drop in the postwar period. Most of the decline was concentrated in purchases of durable goods, which decreased 42.9 percent on an annual-rate basis. The typically more stable nondurables component declined at a 7.1 percent annual rate, while expenditures on services rose by 1.9

percent. In addition, recent surveys indicate that consumer confidence has receded to extremely low levels. The University of Michigan survey, based on interviews conducted during October and November, showed consumer confidence had fallen to its lowest level since the inception of the survey in the late 1940's. The Conference Board consumer confidence index is also at a record low of 39.9 percent, down 9 points from the September-October period. Both surveys indicated that intentions to buy houses, cars, and appliances were at new lows.

The combination of high interest rates and a pessimistic outlook among potential buyers led to another substantial decline in residential construction during the fourth quarter. The real value of building activity was down by 14 percent during the fourth quarter, after having already fallen 21 percent during the first three quarters of the year. New housing starts during the quarter were recorded at a 990,000 annual rate. This is only the second full quarter in which starts have averaged less than 1 million at an annual rate since 1946. While the recent decline in interest rates may stimulate this finance-sensitive industry, the data on new housing permits do not foreshadow an immediate recovery. Permits during the fourth quarter were at their lowest level since the series began in 1959.

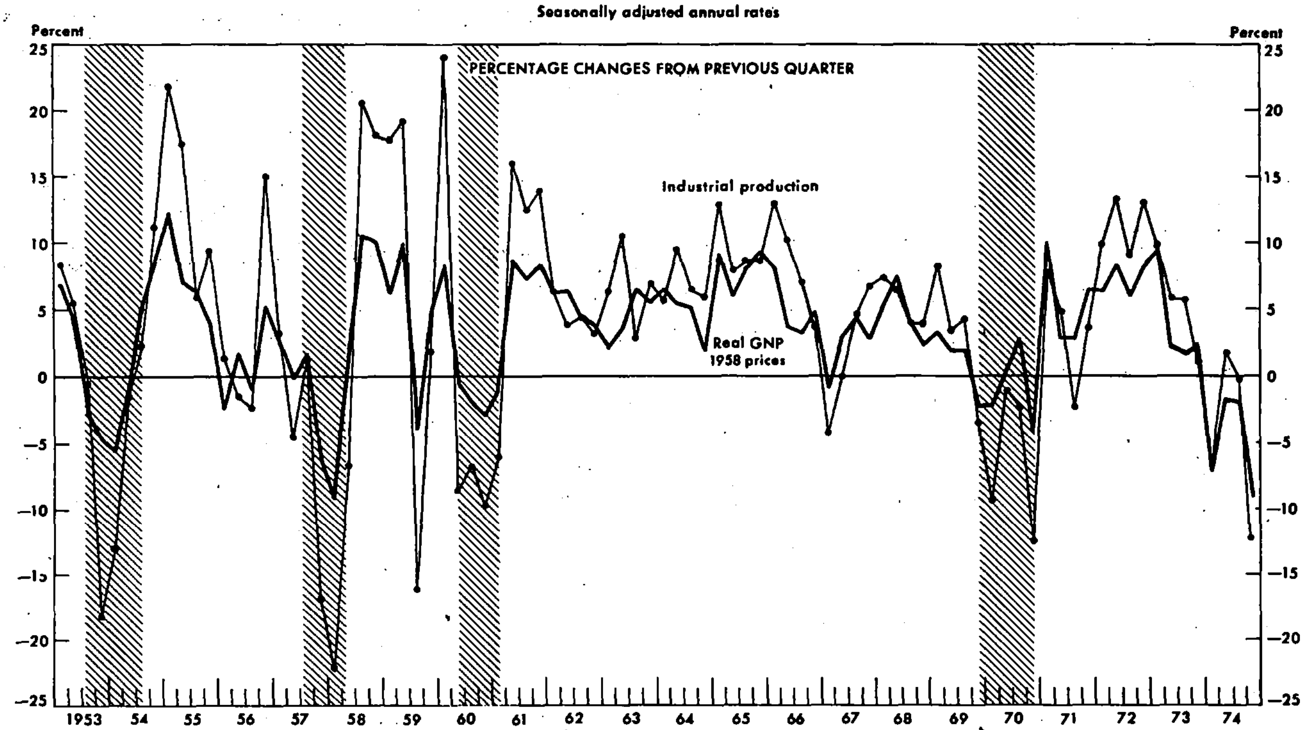
Higher prices accounted for the substantial boost in Government expenditures on goods and services during the fourth quarter. The Federal Government increased its spending by over $5.5 billion to an annual rate of $122.8 billion. Most of the advance was in defense spending, which rose by $5 billion. State and local governments increased their expenditures by $4.5 billion. In real terms, however, total government spending has remained virtually constant since the second quarter of 1974.

In contrast to the other major components of GNP, net exports increased by $1.6 billion in real terms in the fourth quarter, after having declined in two previous quarters.

Chart II

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.

PRICE DEVELOPMENTS

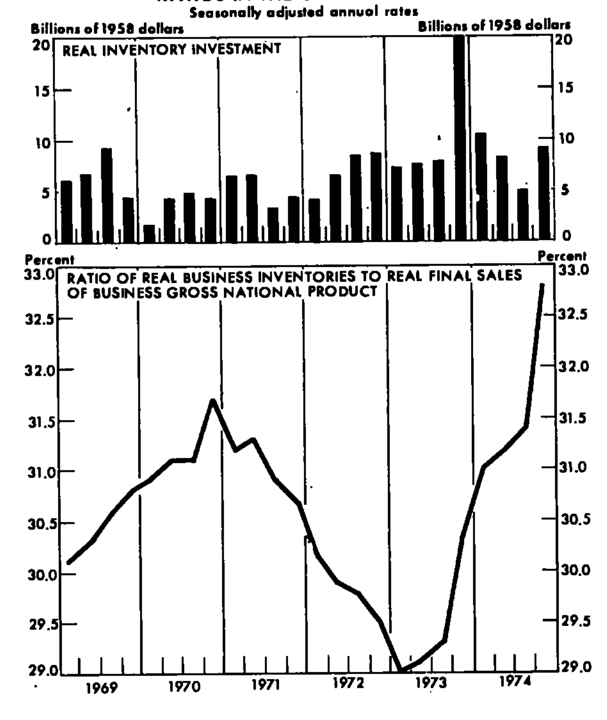
Despite signs of an improving price outlook, prices of final goods and services as measured by the implicit GNP price deflator rose at a 13.7 percent annual rate in the fourth quarter, up somewhat from the 11.9 percent growth rate recorded in the previous quarter. However, this measure appears to have overstated the extent of inflation to some degree. Thus, the fourth-quarter acceleration reflected both the Federal pay raise in October and the change in the composition of output brought about mainly by the drop in gross auto product. The fixed-weight deflator for private GNP increased at a 12 percent annual rate in the fourth quarter, down slightly from the 13.2 percent growth rate in the previous three-month period.

The consumer price index rose at a 9.8 percent annual rate in the final three months of 1974, its slowest quarterly rate of the year. This slowdown occurred despite an acceleration in the advance of retail food prices to a 13.8 percent rate, up from 11.7 percent during the third quarter. The prices of all commodity items except food rose at a 7.1 percent annual rate, well below the third quarter's 15.3 percent rate and less than half the average rate of increase during the first nine months of the year. Service prices in the fourth quarter rose at a 10.5 percent rate, just slightly less than the 11.3 percent average for the year as a whole.

At the wholesale level, however, there has been a substantial moderation in the rate of inflation. The wholesale price index advanced at a 12.7 percent annual rate in the final three months of the year, down from 31.3 percent during the third quarter and an average of 21.5 percent for the first nine months of the year. In December, wholesale prices actually declined at a 5.9 percent annual rate. For the quarter as a whole, the deceleration of prices was most noticeable among industrial commodities, which increased at a 7.9 percent annual rate, down from 25.7 percent in the third quarter. Moreover, this slowdown was quite broadly based, showing up in a large number of commodities including textiles, fuels, and paper products. The prices of farm products and processed foods and feeds rose at a 20.3 percent pace during the final quarter, well below the 49.3 percent rate of the third quarter. Viewed in combination with recent forecasts of larger harvests in the forthcoming season, this sharp fallback in the rate of inflation may signal a general weakening of farm price increases.

To some extent, the relief in industrial prices represents a working-forward of declines in raw materials prices, which have been under way for some months. The spot prices of raw industrial commodities declined 3.6 percent during the third quarter and by an additional 17.6 percent in the fourth. During the same period, increases in the wholesale prices of intermediate materials, excluding food and feeds, dropped from an 8.5 percent rate in the third quarter to 3.3 percent during the fourth.

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



Source: United States Department of Commerce.

WAGES, PRODUCTIVITY, AND EMPLOYMENT

The cost of production continued to rise rapidly during the fourth quarter of 1974, as the compensation paid to labor increased while labor's productivity declined. Compensation per hour worked in the private sector of the economy increased at a 9.3 percent seasonally adjusted annual rate. At the same time, output per hour worked declined at a 5.3 percent rate. This productivity decline, coupled with the higher compensation rates, caused unit labor costs to increase at a 14.7 percent annual rate.

The effective wage of labor covered by collective bargaining increased at a 6 percent annual rate during the fourth quarter, bringing the total increase for 1974 to 9.2 percent. By comparison, the wage gain of contract labor in 1973 was 7 percent. Of the 1974 increase, 4.6 percent resulted from contracts negotiated during the year, 2.6 percent came from previous settlements, and 1.9 percent is attributable to cost-of-living escalator provisions. According to preliminary data from the Bureau of Labor Statistics, collective bargaining agreements—covering 5,000 or more workers—that were negotiated during the fourth quarter of 1974 called for first-year wage and fringe benefit increases of 14.8 percent. This is somewhat higher than the 11.9 percent written into contracts during the third quarter, and well above the 9.3 percent average during the first three quarters of the year. Over their entire lives, new contracts in the fourth quarter will provide average annual increments of 8.7 percent in wages and benefits, compared with 7.1 percent during the preceding three quarters.

Reflecting the sharp decline in the production of goods and services, the seasonally adjusted civilian unemployment rate rose to a postwar record of 8.2 percent in January. The increase in unemployment, up from 7.2 percent in December, was felt by all age groups in the labor force. However, it was particularly pronounced among teenagers. The jobless rate among workers under twenty years of age increased to 20.8 percent in January, while unemployment among prime-age workers, twenty-five years and older, rose to 5.7 percent. Looking at the breakdown by job categories, the January unemployment rate for white-collar workers was 4.6 percent, while the blue-collar rate was 11 percent.