The Business Situation

Economic activity steadied in the second quarter of 1975, following five consecutive quarters of significant decline. While the gross national product (GNP) in real terms dropped again, the reported decline was negligible and was more than completely accounted for by an intensification in the rate of inventory liquidation. Indeed, the latest GNP data suggest that the longest and steepest postwar recession has finally bottomed out. Although the inventory liquidation may well continue for sometime further, it seems clear that businessmen have been successful in bringing stocks into better alignment with sales. Buoyed by consumption spending, final demand as a whole rose in real terms in the second quarter for the first time since mid-1973. As a result of lower income taxes and increased transfer payments, consumers were able to expand their purchases and at the same time to rebuild liquidity. Elsewhere, outlays on housing stabilized in real terms, but business fixed investment spending continued to decline. Conditions in the labor market improved in July as employment rose and the unemployment rate declined to 8.4 percent of the civilian labor force.

On the inflation front, the latest evidence indicates that the deceleration in inflation which began in the fourth quarter of last year extended into the April-June period. The rate of growth of the fixed-weight price index for GNP—which, unlike other GNP deflators, is unaffected by compositional shifts in output—was 6 percent in the second quarter, 1.5 percentage points below the increase in the previous quarter and the lowest recorded since the fourth quarter of 1972. However, recent and prospective developments cast some doubt on whether this favorable trend will continue. While industrial commodity prices have moderated in the face of mounting unused capacity and inventory liquidation, prices of petroleum products and fuel have recently been climbing at a somewhat accelerated pace. Another discouraging factor has been the recent acceleration in food prices. Moreover, spot and future prices of agricultural commodities have jumped in response to reports of large foreign grain purchases. On the wage front, the latest evidence suggests that the slack in the labor market has begun to dampen the growth of wages. The growth of compensation per hour worked decelerated in the second quarter and, coupled with increased labor productivity, the rate of increase in unit labor costs slowed considerably.

GNP 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 rose by $16.8 billion in the second quarter, a 4.8 percent seasonally adjusted annual rate of gain. After adjusting for the effects of higher prices, real GNP inched down at an annual rate of 0.3 percent, in sharp contrast to the 11.4 percent plunge in real GNP in the preceding three-month period (see Chart I). On balance, real GNP in the April-June quarter stood 7.8 percent below the peak attained in the final three months of 1973. This is the longest and steepest drop recorded during any postwar recessionary period.

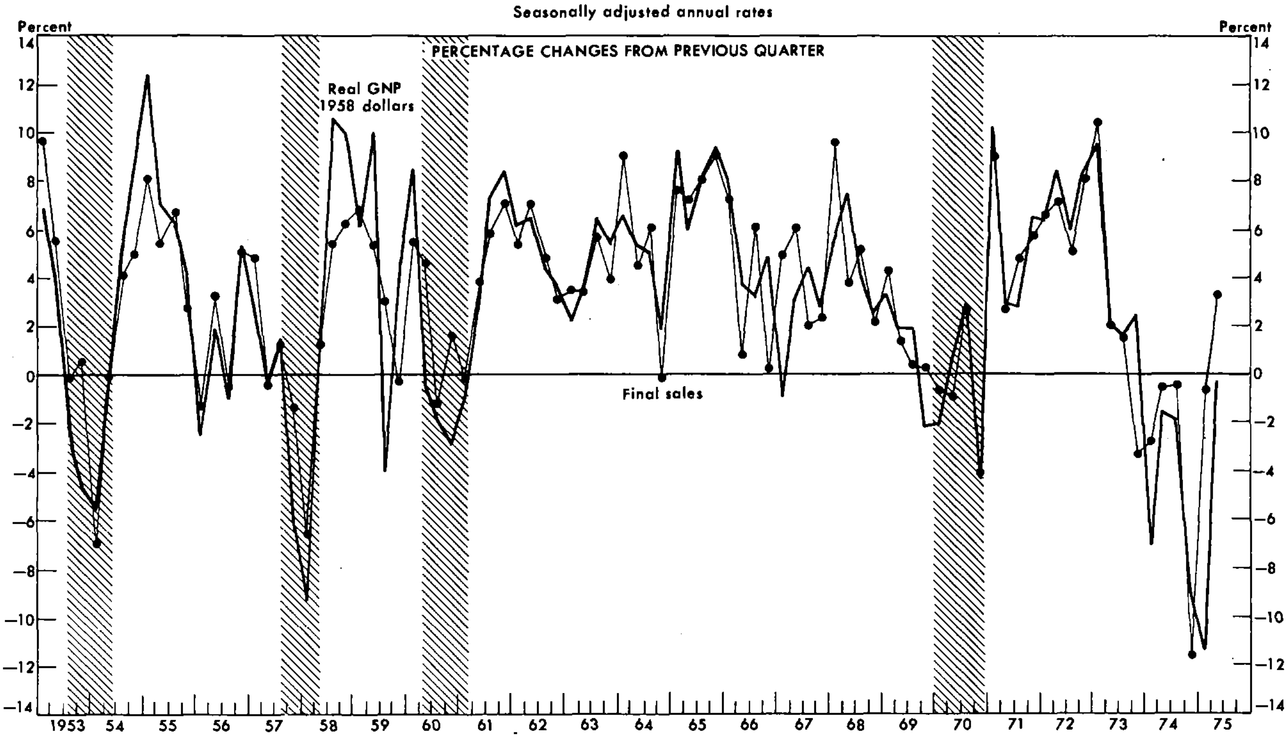
As in the first quarter, the rapid pace of inventory liquidation was the most important depressant on economic activity. Current-dollar final expenditure—i.e., GNP less the change in inventories—rose $31.3 billion, or 9 percent, at an annual rate. In real terms, the increment in final sales amounted to 3.3 percent at an annual rate, the first such gain in six quarters. The increase in real spending resulted from advances in consumer, residential construction, and government outlays that more than offset the drop in business fixed investment.

Preliminary estimates based on partial data indicate that inventory liquidation accelerated to a record rate in the second quarter. In current-dollar terms, businesses reduced their inventories by $33.7 billion, outpacing the very large

Chart I

REAL GROSS NATIONAL PRODUCT AND FINAL SALES

Seasonally adjusted annual rates



Note: Shaded areas represent recession periods, indicated by the National Bureau of Economic Research chronology.
Source: United States Department of Commerce, Bureau of Economic Analysis.

$19.2 billion decline in the first quarter. Despite this massive inventory liquidation, the $14.5 billion restraint on GNP expansion was much smaller than the $37 billion drag in the first quarter, when inventory investment swung from accumulation to decumulation. Although the massive inventory correction acts as an immediate depressant on economic activity, in the long run the liquidation is essential for an eventual pickup in production.

In the first quarter, about half of the swing to liquidation was accounted for by real retail auto inventories. In contrast, inventory liquidation in the April-June interval was much more broadly based, with all major categories posting sizable declines (see Chart II). In retrospect, it appears that the inventory correction commenced late in 1974 in the nondurables trade sector and has spread since then to all major sectors of the economy. Thus, in the second quarter of this year, inventory reductions occurred in the durable and nondurable manufacturing, wholesale, and retail trade sectors. As a result of the massive inventory liquidation and the recent pickup in final sales, the ratio of constant-dollar inventories to final GNP sales has now receded from the extraordinarily high level to which it had risen at the end of 1974. While imbalances probably still remain in certain sectors of the economy, especially durable manufacturing, the overall inventory situation is now vastly improved over what it was at the beginning of the year.

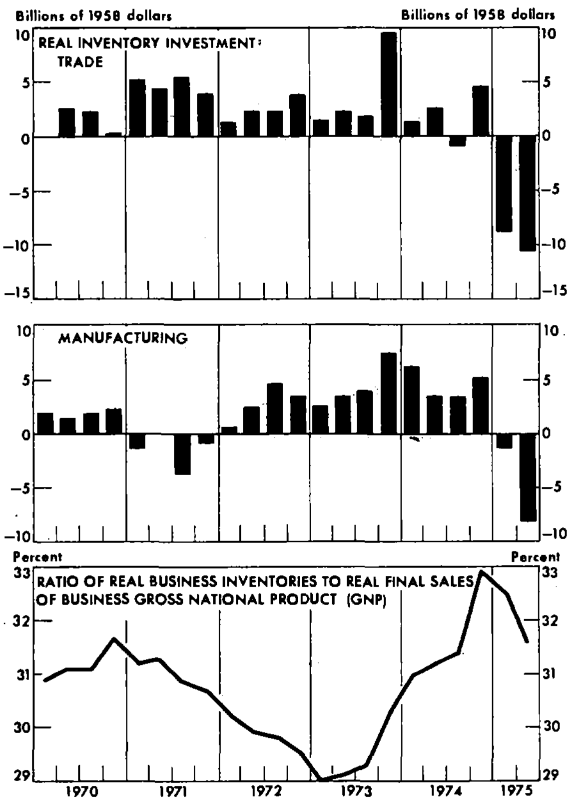
There was in the second quarter a marked improvement in final sales, spurred by a sharp rise in disposable income. Consumers' disposable income surged by $63.3 billion in the second quarter, as tax rebates, cuts in tax-withholding rates, and special supplemental social security transfers swelled spendable income. The jump in disposable income stemmed from a $27.4 billion increase in personal income, coupled with a $36 billion drop in personal tax payments. Part of the gain in personal income was attributable to onetime payments of $50 to social security recipients, while tax rebates amounted to $31.7 billion at an annual rate. Together with an easing in the rate of inflation, real disposable income rose at a 22 percent seasonally adjusted annual rate.

Personal consumer expenditures increased by $24.9 billion in current-dollar terms (see Chart III). In real terms, the gain in personal consumption expenditures was the largest since the first quarter of 1973. With disposable income increasing sharply and consumption spending increasing more moderately, the saving rate soared to 10.6 percent of disposable income, the highest rate of saving since the first quarter of 1946 and well above the 7.5 percent averaged over the previous four quarters. While this accumulated saving is likely to be used initially by

Chart II

REAL INVENTORY INVESTMENT AND REAL INVENTORY-SALES RATIOS IN THE GNP ACCOUNTS

Seasonally adjusted annual rates



Source: United States Department of Commerce.

consumers to reduce instalment debt and rebuild liquidity, it will at the same time provide a foundation for stronger consumer spending in future months. Moreover, the impact of lower withholding schedules and extended unemployment benefits will continue to be felt in the future, and an 8 percent cost-of-living increase in social security benefits will also boost disposable income. The gain in real consumer spending reflected higher outlays for durable and nondurable goods as well as for services. Real service expenditures increased at a 4.8 percent annual rate. Real spending on consumer durables rose at a 10 percent annual rate in the June quarter, with auto expenditures expanding at a 9 percent annual rate and nonauto spending rising at a 10.5 percent annual rate. Sales of domestically produced cars have edged up steadily in recent months, running at 7.1 million units in June as compared with the 6 million units sold in March. Nondurable goods outlays rose at a 6.3 percent annual rate, the largest increase since the fourth quarter of 1972.

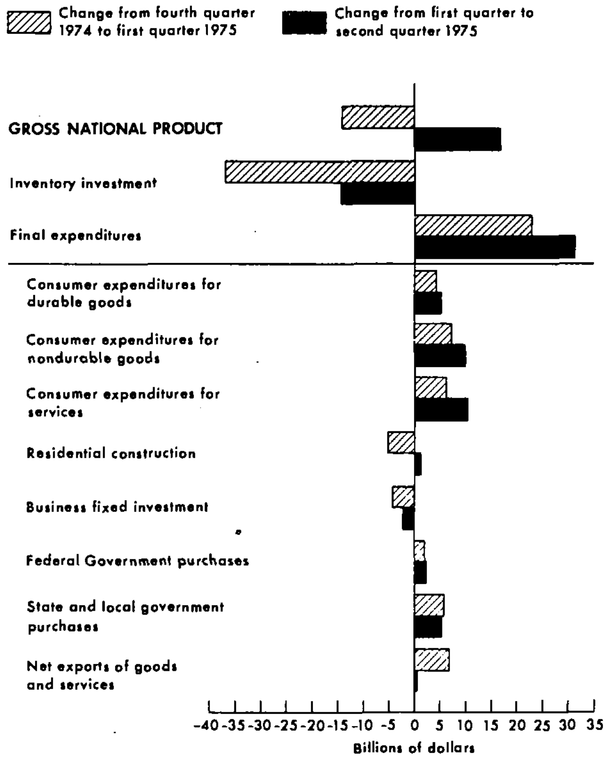
After skidding for two years, real residential construction spending edged up in the second quarter. To be sure, the increase was negligible, but it nonetheless suggests that the collapse in housing has ended. Most other measures of housing activity confirm the pickup in home building, but the strength of the recovery is still uncertain. Permits to build new homes rose each month of the quarter and, over the quarter, averaged 892,000. While this remains a depressed rate by historical standards, it is 30 percent higher than the first-quarter average. Another encouraging factor has been the improvement in sales of single-family homes. Sales are now at their highest level since May 1974. No doubt the tax credit on purchases of new, previously unoccupied houses is a factor in the sales pickup. On a newly built home of $40,000, which is close to the median price of new one-family homes, the 5 percent tax credit works out to be roughly equal to a 20 percent reduction on a 25 percent downpayment. The ratio of unsold new homes to sales fell in May to its lowest level in nearly two years. Despite the recent upturn of short-term interest rates, rates on time and savings deposits have remained relatively attractive and deposit growth at thrift institutions has continued to accelerate. In June, deposits at savings and loan associations and mutual savings banks rose at close to a 20 percent annual rate. Thus, the outlook for housing remains moderately encouraging, as the increased inflow may lead to further easing in mortgage lending terms.

Business fixed investment declined $2.3 billion in the second quarter, as the drop of $2.6 billion investment in structures more than offset a $0.2 billion increase in producers' durable equipment. In real terms, plant and equipment outlays fell for the fourth consecutive quarter.

Chart III

RECENT CHANGES IN GROSS NATIONAL PRODUCT AND ITS COMPONENTS

Seasonally adjusted



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

In light of the current low levels of capacity utilization, there is little reason to look for a turnaround in spending. Indeed, the most recent Commerce Department survey of capital spending plans, taken in late April and May, indicates such a meager increase in nominal outlays in 1975 that a decline in real terms seems certain. Outlays on new plant and equipment are expected to be only 1.6 percent higher than in 1974.

PRICE DEVELOPMENTS

By virtually every measure, inflation continued to decelerate over the April-June period. Prices of goods and services, as covered by the implicit GNP price deflator, advanced at a 5.1 percent annual rate in the second quarter, down substantially from the 8.4 percent advance recorded in the previous three-month period. In part, however, it appears that the slowdown in the implicit GNP deflator overstated the actual improvement because of the changing composition of output, especially the sizable pickup in the level of auto production between the first and second quarters. The fixed-weight price index, which holds constant the composition of output, improved more modestly, with its annual rate of increase falling from 7.5 percent in the first quarter to a 6 percent rate in the second quarter.

To the relief of consumers, the rate of inflation in retail prices is now running well below the double-digit range. Since peaking at an 11.9 percent annual rate in the third quarter of 1974, the rate of advance of consumer prices has eased considerably. In the second quarter, such prices rose at a 5.8 percent annual rate, the slowest quarterly rate of increase since the end of 1972. This deceleration reflected a sharp slowdown of inflation in the prices of nonfood commodities and services, as well as food. However, it appears that the volatile food component is headed back up. Led by rapid increases in the price of meat, the increase in food prices accelerated each month of the quarter. Nonfood commodity prices rose at a 6.7 percent annual rate over the quarter, less than half of the 13.6 percent rate of increase a year earlier. Service prices in the second quarter rose at a 6.1 percent annual rate, compared with a 9.3 percent annual-rate advance in the previous quarter.

At the wholesale level, prices of industrial commodities continued to decelerate, rising at a 2.6 percent annual rate over the April-June period. This was in sharp contrast to the year-earlier quarterly increase that exceeded 30 percent at an annual rate. The deceleration would have been even more pronounced if power and fuel prices had not begun to rise rapidly again. Unfortunately, the near-term outlook for energy prices is not encouraging. The full impact of import fees of $2 per barrel on crude oil and 60 cents per barrel on refined petroleum products is still to be felt and undoubtedly will add to pressures on energy prices. In addition, energy prices could accelerate even further in the event that either domestic crude oil prices are decontrolled or the Organization of Petroleum Exporting Countries (OPEC) cartel raises its price of oil. Excluding power and fuel, industrial commodity prices rose only at a 2.2 percent annual rate in June. After declining in the first three months of 1975, wholesale agricultural prices increased at a 16 percent annual rate in the second quarter. As a consequence, wholesale prices as a whole rose at a 7 percent annual rate in the second quarter after declining in the first quarter. To a large extent, the turnaround in agricultural prices reflected a jump in the prices of livestock and meat, as prices of hogs and beef cattle have soared recently.

In July the outlook for food prices was clouded by reports of drought damage to USSR crops and by news that the Soviets were seeking to purchase substantial amounts of wheat and corn from the United States. Despite forecasts of record domestic production of corn and wheat, prices of these commodities have jumped sharply. As of the end of July, the USSR had contracted to purchase 9.8 million metric tons of domestic wheat, corn, and barley. Although it is clear that the increased Soviet demand for United States grain exports will lead to higher prices of corn and wheat, it does not appear that these purchases will precipitate the skyrocketing prices of 1972-73. With the exception of the USSR, prospects for an increase in worldwide production appear good, and production estimates suggest that carry-over stocks in this country at the end of the year will likely be larger than at the beginning.

WAGES, PRODUCTIVITY, AND EMPLOYMENT

Recent data indicate that the pace of wage increases has slowed in the past several months. Over the April-June interval, compensation per hour worked, which includes wages and fringe benefits, rose in the private nonfarm sector of the economy at a seasonally adjusted annual rate of 7.2 percent, a slower pace than the 10 percent increase averaged in the previous four quarters. The slowdown in wage gains has also been mirrored in other wage series. Average hourly earnings increased at a 5.1 percent annual rate in the second quarter, compared with an 8.5 percent advance recorded in 1974. However, because movements in this series reflect not only wage changes but also changes in manufacturing overtime and interindustry shifts in employment, a better measure of wage-rate changes is the adjusted hourly earnings index. After adjusting for changes in overtime in manufacturing and interindustry shifts, the gain in average hourly earnings slowed to 6.9 percent at a seasonally adjusted annual rate in the second quarter, the third consecutive quarter of slower wage gains and the lowest rate of increase since the first quarter of 1974. Over 1974 as a whole, adjusted average hourly earnings climbed at a 9.1 percent rate.

Developments reported in the separate survey of major collective bargaining agreements also reveal a modest slowing in the rate of wage increases, although the gains remain sizable. In collective bargaining agreements covering 5,000 or more workers, contracts settled in the second quarter provided for a 9.3 percent annual rise in wages and benefits over the first year of the contract and 7.7 percent annually over the contract life. In contrast, the increases in contracts signed in 1974 averaged 10.7 and 7.8 percent, respectively. For wages alone, settlements covering 1,000 or more workers in the second quarter provided for first-year increases of 9.8 percent, compared with 12.5 percent in the preceding three-month period. Because union negotiators have concentrated on winning large first-year wage increases, the relatively light calendar of major contracts that expire in 1975 should tend to help moderate wage pressures, since most union workers will be receiving the relatively smaller second- and third-year increases provided by agreements signed in earlier years. This tendency is reflected in the Bureau of Labor Statistics' effective wage series, which includes gains arising from current settlements, deferred increases negotiated in earlier years, and additional gains from escalator clauses. In the second quarter, the effective wage rate rose at a 7.8 percent annual rate after advancing 9.4 percent in 1974.

Productivity, as measured by output per hour of work in the nonfarm private economy, rose at a 3.4 percent seasonally adjusted annual rate over the April-June period, the first increase in more than two years. This advance, however, resulted from a decline in hours worked which exceeded the decline in total production. Typically, during the early stages of a cyclical recovery, productivity tends to pick up sharply as producers are able to utilize idle capacity more efficiently without large additions to their labor force. However, some analysts have argued recently that productivity increases in coming months may be subnormal for this phase of the business cycle since durable manufacturing industries may post smaller productivity increases than in typical recoveries. These analysts foresee only a modest recovery in the production of durable goods which ordinarily have bounced back sharply. In any event, the prospect of a moderate increase in unit labor costs this year looks promising since productivity growth, even if sluggish, is still likely to mitigate wage gains somewhat. In contrast, productivity declined continuously in 1974. In the second quarter, because of the deceleration in compensation and gains in productivity, unit labor costs in the private nonfarm sector rose at a seasonally adjusted 3.9 percent, the slowest annual rate of increase since late 1972 and far below the 14 percent advance posted in 1974.

According to the household survey, labor market conditions improved in July as the rate of joblessness fell to 8.4 percent. This was the second consecutive monthly decline and left the unemployment rate at its lowest level since February. Since the unemployment rate in June had been artificially depressed by faulty seasonal adjustment procedures, it was widely expected that the jobless rate would post a substantial increase in July. Under these circumstances, it seems likely that the 0.2 percentage point decline in July may understate the actual degree of labor market strengthening. Despite this, the unemployment rate remains high by historical standards and, moreover, it remains to be seen if some of the improvement was an aberration. Typically, the unemployment rate tends to lag somewhat behind the pickup in economic activity, since employers expand production initially by lengthening the workweek of their work force without recalling laid-off workers or hiring new ones. In addition, as job prospects improve, this often encourages individuals who have stopped looking for employment to seek jobs, thus tending to swell the labor force and raise the rate of unemployment. Whatever the near-term behavior of the unemployment rate, employment has begun to expand. In July, total employment registered its fourth consecutive increase, advancing by 634,000 workers to its highest level in seven months. The number of unemployed persons fell in July to the lowest level since February. Most labor force groups shared in the improvement in employment; in addition, the number of persons working part time because they couldn't find full-time employment declined sharply in July, dropping by 175,000.

While the household survey points to an increased pace of employment growth, the separate payroll survey indicates a more modest advance in employment. Of course, the household and payroll surveys may diverge because of differences in definition, coverage, sources, and estimation procedures. In July, the survey of nonfarm establishments indicated that employment rose by 88,000 as employment in services, trade, and state and local government expanded. Employment in construction declined slightly but this may have reflected the effects of increased strike activity. Manufacturing employment also dipped slightly, but average weekly hours worked in manufacturing jumped to the longest workweek since November 1974. While the household survey points to a much faster employment growth than the payroll survey, the payroll survey nevertheless suggests that the employment gain was broadly based. The percentage of nonfarm industries experiencing increases in employment rose to 54.9 percent, the highest level in more than a year.