Chapter 2

Prospects for Cost-Price Stability

AS THE ECONOMY enters its sixth year of uninterrupted expansion and its third successive year of high growth, the gap between potential and actual production is fast disappearing. Unemployment is near 4 percent, and operating rates in many industries are moving close to preferred rates. The past 5 years have demonstrated that the economy can operate free of recurrent recession. Now the United States is entering a period that will test whether sustained full utilization of our human and physical resources is possible without the injustice, dislocation, and decline in competitive position that accompany inflation.

History alone is not reassuring. Still, there are sound reasons for confidence that a higher degree of cost and price stability can be achieved at high employment than during previous such periods since World War II. The pattern of economic activity shows superior balance. Productivity gains are larger and more extended. Private attitudes in key wage and price decisions are considerably more responsible. New competition from abroad reinforces keen domestic competition for markets, and new policies of active manpower development are permitting the fuller use of our human resources.

If both full employment and price stability can be maintained, the United States will enjoy continuing real growth that will provide abundant resources to meet simultaneously the demands of national security and of domestic welfare. The last few years have shown what the American economy can do when its progress is free of interruption. Incomes from wages and profits have leaped ahead. With over-all unemployment down sharply, the disadvantaged groups that suffered most during the period of slower growth are improving their positions. If the economy remains on its path of balanced growth, it will be an engine of great social progress, and—together with the Great Society programs—will move us steadily closer to our ideals. But only if inflation can be avoided will prosperity be sustainable and the economy achieve its full promise.

DETERMINATION OF THE PRICE LEVEL

The relation between the volume of economic activity and the price level is not simple. As a first approximation, the classical law of supply

and demand leads one to expect that the change in the price level will depend mainly on the size of the gap between capacity and actual output. The more production falls short of potential—i.e., the greater is excess productive capacity—the further prices should drop. Conversely, when demand outruns aggregate supply, the imbalance should raise prices. History shows that things are rather more complicated. For example, the second half of 1955 was a period when there was no gap between potential production and actual production, yet the GNP deflator—our most comprehensive indicator of the price level—rose little. In 1957 and 1958, when the gap was beginning to assume considerable size, the GNP deflator rose substantially. The GNP deflator rose at a fairly steady and modest pace, both in the years when the gap was large—in 1958–61—and when it narrowed substantially—from 1961 to 1965. Clearly, more detailed analysis is necessary.

Some important components of the price level have risen continuously over the years, particularly in construction, services, and Government. Other components of the price level, especially agricultural and some raw material prices, are influenced by supply conditions which move relatively independently of the general economy.

The industrial component of the price level has proved to be most systematically responsive to the general degree of prosperity. But even industrial prices cannot be accurately predicted by reference to levels of activity alone. For example, industrial prices have been much more stable for any given degree of utilization of industrial capacity in the last 5 years than in the preceding decade.

Industrial price movements are mainly determined by four elements:

First, prices move roughly parallel with the basic cost trends. This does not mean that the causation runs wholly from costs to prices. Both are subject to many common influences; moreover, prices directly influence costs because wage increases respond in part to price and profit levels. But clearly, other things equal, higher costs tend to raise prices.

Second, the state of demand affects prices. When markets are weak and part of capacity is idle, list prices are discounted and may even be lowered. Delivery periods are shortened, quality may be raised, freight absorbed, and other terms of the transaction changed. When markets become stronger, business finds it easier to raise prices. Once shortages develop and industry is unable to keep shipments in pace with desired purchases, the likelihood of price rises becomes very much greater.

Third, the nature of the price-setting process of an industry can influence the price changes associated with any given set of cost and demand conditions. In highly concentrated industries, where a few producers or a single price leader can determine prices, the response may be quite different from that in an industry of many small firms, where wholly impersonal market forces keep supply and demand in balance through price adjustments. Differences are especially great in bad times. In competitive industries, prices are likely to fall; in concentrated industries, production is more likely

to be cut back, with only limited price adjustments. When markets are roughly in balance, the sequence and magnitude of price changes is less predictable. What happens in the more concentrated industries depends on the price policies followed by the principal producers. The Government's price guidepost is an attempt to avoid inflation resulting from industry's use of discretionary pricing power.

Expectations and attitudes also affect actual price changes. An economy accustomed to price stability is less vulnerable to inflation. Price adjustments to changing conditions come more slowly and moderately, and include both pluses and minuses. It is free of the inventory hoarding that adds to inflationary demands. And speculation in commodities does not raise raw material costs. Conversely, when an inflationary psychology takes hold, inventory hoarding and anticipatory placing of orders accentuate any market imbalances and further raise costs of production and distribution.

Finally, in a mixed economy such as ours, Government actions have an important effect on industrial prices. Fiscal policies help determine the over-all size of markets. The Government is the biggest customer for many industries and hence the largest single influence on demand. It also affects competitive conditions through tariff policies, quotas, and other forms of protection, through regulatory policies, stockpile, and commodity stabilization policies, and in other ways. If the objective of price stability is given recognition in the full range of economic policies, prices will be more stable.

THE PRICE RECORD

Our over-all price record during the present expansion has been remarkable—unmatched by any industrialized nation. But during 1965, the record developed some blemishes; prices, as measured by any of the major indicators, advanced more rapidly.

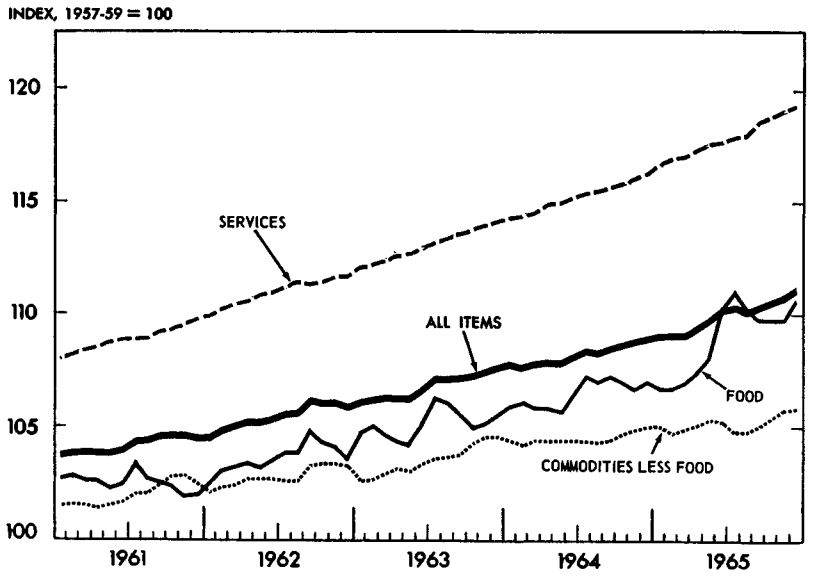
After increasing at an average annual rate of 1.3 percent between 1960 and 1964, the GNP deflator rose by 1.8 percent in 1965. The most prominent elements in this acceleration were more rapid increases in the deflators for construction, nondurable goods, and the Federal Government (reflecting the large military pay increase in 1965).

Consumer prices rose at an average annual rate of only 1.2 percent a year from 1960 to 1964, but by 1.7 percent in 1965 (Chart 7). Substantial advances in the prices of food, apparel, and footwear were mainly responsible for the faster rise. The reduction of excise taxes mitigated the increase of the index by 0.2–0.3 percent.

The wholesale price index increased 2.0 percent from 1964 to 1965 after 4 years of stability (Table 8 and Chart 8). Farm and food products accounted for over half of this increase. Industrial prices, which had remained virtually constant from 1960 to 1964, moved up by 1.3 percent last year. Increases were found particularly in nonferrous metals, nonelectrical machinery, fabricated structural products, gas fuels and petroleum, lumber, fertilizer materials, hides and skins, and manufactured animal feeds.

Chart 7

Consumer Prices



SOURCE: DEPARTMENT OF LABOR.

In some respects, price behavior in 1965 showed a continuation of the healthy pattern that has characterized the present expansion. Prices in such important sectors of manufacturing as automobiles, steel, and electrical machinery remained essentially stable, and there were still many declines.

TABLE 8.—*Changes in wholesale prices, 1961–65*

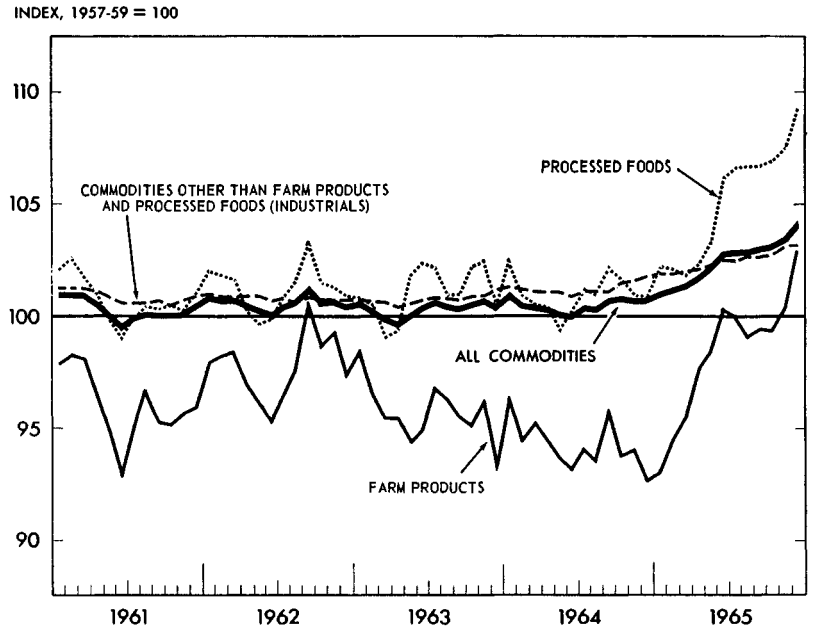
Commodity group	Percentage change [1]		Contribution to total change (percent) [1]	
	1961 to 1965	1964 to 1965	1961 to 1965	1964 to 1965
All commodities	2.2	2.0	100	100
Farm products	2.5	4.3	12	23
Processed foods	4.4	4.1	29	30
All other than farm products and processed foods (industrials)	1.7	1.3	59	47
Textile products and apparel	2.1	.6	7	3
Hides, skins, leather and leather products	2.8	4.4	2	3
Fuels and related products, and power	−1.8	1.9	−7	7
Chemicals and allied products	−1.7	.7	−5	2
Rubber and rubber products	−3.3	.4	−2	[2]
Lumber and wood products	5.4	.5	7	[2]
Pulp, paper, and allied products	1.1	.9	2	2
Metals and metal products	5.0	2.8	31	19
Machinery and motive products	1.4	.8	12	7
Furniture and other household durables	−1.5	−.5	−3	−1
Nonmetallic mineral products	−.1	.2	[2]	[2]
Tobacco products and bottled beverages	4.4	.3	5	[2]
Miscellaneous products	6.8	1.6	10	3

[1] Based on preliminary data for December 1965.
[2] Less than 0.5 percent.

Source: Department of Labor.

Chart 8

Wholesale Prices



SOURCE: DEPARTMENT OF LABOR

Some of the increases reflected nonrecurring factors. The rise in prices of nonferrous metals reflected increases of world prices which do not influence adversely our competitive position. And the sharp rise in food prices in large part reflected production cycles in agricultural products.

SUPPLY AND DEMAND IN THE PRODUCT MARKETS

The fiscal and monetary policies outlined in Chapter 1 are intended to assure that total civilian and military purchases of goods and services do not exceed the economy's ability to produce. But price pressures can also develop from imbalances within specific sectors. If prices do not fall in sectors where potential supply exceeds demand as readily as they increase where demand outruns supply, imbalances in the composition of demand will raise the price level.

In recent years, measures have been developed which can serve as rough indicators of the supply-demand relationships of specific industries.

OPERATING RATES OF INDUSTRIES

Operating rates of industries are a direct measure of the relation between production based on current demand and the capacity to produce. Although the concept of capacity is an elusive one, most producers seem

able to give it quantitative meaning, and also to identify a rate of utilization of that capacity which is "preferred"—presumably a level of operation which management feels can be sustained efficiently for an extended period.

Starting from a low of 77 percent at the beginning of the expansion (compared with an average preferred rate of 92 percent), the seasonally adjusted average rate of utilization of manufacturing capacity as measured by McGraw-Hill rose by 6 points, to 83 percent at the end of 1961. During the following year, a parallel growth of output and capacity kept utilization rates rather steady. In 1963, output began to rise faster, raising average utilization to 88 percent by the end of 1964.

The strength of industrial investment in 1965 enabled capacity in manufacturing to increase by an estimated 5½ percent. Manufacturers increased output dramatically without running into significant bottlenecks. The average operating rate climbed to 89 percent by the end of the year as the gain in the rate of output accelerated under the impetus of investment and military demand.

The pattern of investment last year contributed to the general balance between output and capacity. Of the four industries which were operating at or above their preferred rates in December 1964, two subsequently succeeded in building up their productive capacity by more than the growth of output (Table 9). Others, which were operating below preferred rates at the end of 1964, added more slowly to capacity in 1965, so that they, too, came closer into balance.

In four industries, high demand has raised production beyond preferred utilization rates. In three of these industries, particularly large increases of investment are planned for the first quarter of 1966.

TABLE 9.—*Manufacturing capacity utilization, 1964–65*

Industry	Output as percent of capacity [1]		Preferred rate (percent) [2]
	December 1964	December 1965	
Total manufacturing [3]	88	89	92
Iron and steel	88	75	91
Nonferrous metals	98	103	95
Machinery	87	91	91
Electrical machinery	84	91	93
Autos, trucks, and parts	95	93	96
Other transportation equipment	80	93	88
Fabricated metals and instruments	87	94	92
Stone, clay, and glass	80	85	88
Chemicals	85	85	90
Paper and pulp	94	93	97
Rubber	96	94	94
Petroleum and coal products	91	91	95
Food and beverages	86	84	86
Textiles	96	98	96
Miscellaneous manufacturing	88	89	94

[1] Data for 1964 except iron and steel from McGraw-Hill; estimates for iron aud steel for 1964 and all industries for 1965 by Council of Economic Advisers after consultation with McGraw-Hill.
[2] From McGraw-Hill survey of business plans for new plant and equipment, April 1963.
[3] Not comparable with data in Table C-34 because of differences in methods of computation.

Sources: McGraw-Hill Publishing Company, Board of Governors of the Federal Reserve System, and Council of Economic Advisers.

When the operating rate for all manufacturing averages (say) 2 points below the preferred rate, there will be less price pressure if each individual industry shows a similar 2-point gap between its actual and its preferred rates than if some are above preferred rates and some far below. While there are always some differences among industries, the balance was unusually favorable in 1965. Sectoral balance can be measured by the weighted average of the absolute amounts by which the gap between each industry's own operating rate and its own preferred rate exceeds the gap between the operating rate for all manufacturing and the preferred operating rate for all manufacturing. This average "excess gap" was 1.7 percentage points in 1965, down from 2.9 in 1964. In contrast, the average "excess gap" was 6.6 in 1955, reflecting the severe sectoral imbalance of that high employment year. Investment expected in 1966 will raise manufacturing capacity by about 7 percent. This should keep the average operating rate essentially unchanged from 1965. The sectoral composition of rates should also continue in general balance.

For the nonmanufacturing sectors of the economy, less information is available on capacity utilization. Indexes prepared at the University of Pennsylvania show that operating rates outside of manufacturing rose by 1 to 4 points in the last year, as output rose substantially (Table 10). Output is expected to rise again considerably in 1966, but the anticipated high rates of investment should generate rapid growth of capacity as well.

TABLE 10.—*Capacity utilization and change in output of selected industries, 1964–65*

Industry	Capacity utilization (percent) [1]		Percentage increase in output, 1964 to 1965 [3]
	1964	1965 [2]	
Coal mining	64	68	4
Metal mining	78	81	6
Stone and earth minerals	94	97	6
Electric utilities	90	91	8
Gas utilities	94	96	5
Services [4]	95	96	(5)

[1] Output as percent of the trend line through peaks in output, except for services.
[2] Average of first 3 quarters.
[3] Average of available months in 1965 over average of equivalent period in 1964. Based on seasonally adjusted data.
[4] Includes air and rail transport, office space rental, and residential housing. For method of computation, see R. Summers, "An Index of Capacity Utilization in Service Industries," Wharton School of Finance.
[5] Not available.

Sources: Wharton School of Finance and Board of Governors of the Federal Reserve System.

BACKLOG OF ORDERS

In those industries where production is based significantly on orders (mainly durable goods industries), the relation of orders to shipments provides further indication of the state of demand relative to supply in the market. Since producers wish to translate an irregular flow of orders into a smooth production schedule, some backlog of orders is normal and desir-

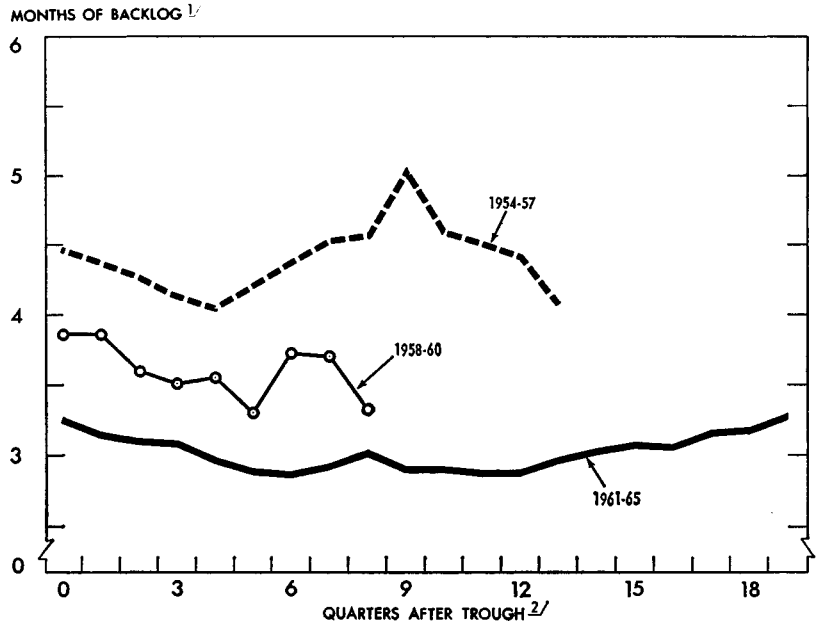
able. But when the ratio of unfilled orders to shipments increases rapidly, it may indicate that demands are exceeding producers' present supply capabilities, or that buyers are placing orders for future delivery farther ahead.

During recent years, the ratio of unfilled orders to shipments in the durable goods industries as a group has been roughly constant, equal to a backlog of about 3 months. In the two previous expansions, the orders backlog was both substantially higher relative to sales and considerably less stable (Chart 9). The average backlog reached 5 months in 1956, indicating the clear presence of excessive demand in some sectors.

Today, there is only isolated evidence of undue buildups of orders. The absolute volume of unfilled orders has increased in almost every industry. But the over-all increase in the backlog relative to shipments over the last 12 months was moderate. Increases of up to 0.3 month occurred last year in all durable goods industries except primary metals, where the backlog declined by 0.2 month, reflecting the steel adjustment. In the 1954–57 expansion, the backlog for the entire group of durable goods industries rose by as much as 0.9 month in a 12-month period.

Chart 9

Backlog of Manufacturers' Unfilled Orders for Durable Goods in Three Postwar Expansions



1/ RATIO OF UNFILLED ORDERS (END OF QUARTER) TO SHIPMENTS (QUARTERLY AVERAGE); EXCLUDES INDUSTRIES WITH NO ORDERS. BASED ON SEASONALLY ADJUSTED DATA.
2/ TROUGH QUARTERS FOR GNP WERE 1954 II, 1958 I, AND 1961 I.
SOURCES: DEPARTMENT OF COMMERCE AND COUNCIL OF ECONOMIC ADVISERS.

In 1966, order backlogs are likely to increase somewhat further under the impetus of rising demand. But the rapid rise of capacity should generally permit shipments to respond to rising orders, preventing the emergence of major price pressures from this source. However, this indicator of demand pressures will need to be followed closely. Should order books lengthen substantially, the efficient and moderate inventory policies that have kept orders at reasonable levels could be altered, leading to imbalances in industrial markets.

SUPPLY AND DEMAND IN THE LABOR MARKETS

Cost-price stability cannot be achieved if the supply of labor is inadequate to allow production to respond freely to demand. When workers having the needed skills are readily available for employment, industry is able to utilize its physical capacity fully and efficiently. When major labor shortages develop, they may be translated into production bottlenecks that limit the supply of finished products and thereby result in demand pressure on prices. Alternatively, or in addition, tight labor markets put upward pressures on labor costs, as unions press for excessive wage increases and employers bid against each other for the skills in short supply, and as employers are forced to hire less qualified workers with resulting lower productivity.

The growth of the U.S. labor force has accelerated since 1962. From 1955 to 1962, the average annual increase was 825,000. During the last 3 years, it averaged 1.2 million, and in 1965 the increase was 1.4 million. This acceleration resulted mainly from the high birth rates following World War II and the increased participation of women in the labor force, partly in response to more favorable job opportunities.

The employment gains of recent years have been large and widely distributed. Every labor force group has benefited from the sustained economic growth which has created an average of more than 1.3 million additional jobs a year since 1961. During the past 2 years, especially large gains have been made by teenagers, adult nonwhites, the long-term unemployed, and the unskilled. This pattern gives testimony not only to the power of high economic growth to bring benefits to inexperienced and disadvantaged workers, but also to the ability of employers effectively to absorb such workers into productive employment. If this pattern can continue, the supply of labor will be sufficient to meet manpower needs without serious bottlenecks.

The capacity of labor markets to adjust can be seen from a study of employment gains by occupation. In 1965, for example, employment in professional and technical occupations rose by 333,000; but in 1964 there had been only 150,000 unemployed workers whose last employment was in these occupations. Since there was a reduction of unemployment of such workers of only 17,000 between 1964 and 1965, a minimum of 316,000 new professional and technical employees must have come from among new entrants into the labor force, from upgrading, or through hiring of unemployed whose

last employment was in some other type of occupation. Similar comparisons can be made for other occupations.

Negroes and teenagers found better job opportunities as the labor market tightened (Table 11). When the job market was slack and output grew

TABLE 11.—*Changes in employment, 1961–65*

Type of change and period	Total [1]	Teenagers	Nonwhites	Adult whites
Change in employment (thousands of persons):				
1961–62 [2]	1,203	237	159	813
1962–63	963	−38	137	847
1963–64	1,548	268	246	1,075
1964–65	1,822	558	267	1,038
Percentage change in employment:				
1961–62	1.8	4.6	2.3	1.5
1962–63	1.4	−.7	1.9	1.5
1963–64	2.2	5.1	3.4	1.9
1964–65	2.6	10.0	3.6	1.8
Percent of total employment change:				
1961–62	100.0	19.7	13.2	67.6
1962–63	100.0	−3.9	14.2	88.0
1963–64	100.0	17.3	15.9	69.4
1964–65	100.0	30.6	14.7	57.0

[1] Detail shown will not add to totals because of duplication (nonwhites include some teenagers).
[2] Data for 1962 are adjusted for comparability with data for 1961.

NOTE.—Teenagers include those 14–19 years of age; nonwhites, 14 years of age and over; and white adults, 20 years and over.

Sources: Department of Labor and Council of Economic Advisers.

only enough to create jobs for the normal increase in the labor force, adult whites secured the largest share of new jobs. But in 1965, when over-all employment increased by a very large 2.6 percent, nonwhite employment rose by 3.6 percent, and teenage employment increased by 10.0 percent, representing nearly one-third of the total additional employment.

These employment gains, combined with the changes in the labor force, resulted in an improvement in the pattern of unemployment. Unemployment rates for white teenagers fell despite the great influx of this group into the labor force, and rates for nonwhite adults fell to 5.8 percent by the end of 1965. Nonwhite teenagers were an exception; their rates remained very high (Table 12).

TABLE 12.—*Unemployment rates for selected groups, 1960–65*
[Percent]

Period	Teenagers		Adults			
	White	Nonwhite	Men	Women	White	Nonwhite
Annual average:						
1960	12.4	22.1	4.7	5.1	4.3	9.1
1961	13.8	25.4	5.7	6.3	5.3	11.2
1962	12.0	23.7	4.6	5.4	4.2	9.8
1963	14.0	28.4	4.5	5.4	4.2	9.3
1964	13.3	26.2	3.9	5.2	3.8	8.2
1965	12.2	25.3	3.2	4.5	3.3	6.6
1965: IV [1]	11.1	27.1	2.8	4.2	2.9	5.8

[1] Based on seasonally adjusted data.

Sources: Department of Labor and Council of Economic Advisers.

So far, the ability of both workers and employers to adjust rapidly to changing economic conditions has permitted the economy to move toward full employment without experiencing significant labor shortages which could retard growth or endanger price stability.

As production has expanded and the hiring of certain skills has become more difficult, managements have resorted to the normal procedures used in prosperity to economize on skilled labor: redesigning and subdividing of specific jobs; upgrading of experienced employees to more skilled classifications; intensifying on-the-job training for younger workers; stepping up investment to modernize facilities; wherever possible, concentrating the increase of production in plants in areas of labor surplus; hiring women for jobs usually filled by men; recruiting workers abroad; hiring students on a part-time basis; and raising starting salaries.

According to data recently gathered by the Department of Labor, noticeable shortages were reported only among engineers, teachers, technicians, skilled metal workers, and certain kinds of repairmen. Shortages of some of these types of workers have been common for some years, but they have not interfered with rapid gains in production.

Some difficulties in recruiting labor have been reported by employers in medical services, restaurants, and laundries. Employment in household services actually declined between 1964 and 1965. These are generally the low-wage sectors of the economy. Hourly earnings in laundries, for instance, are more than 40 percent lower than those in manufacturing and 30 percent below the earnings in wholesale and retail trade. When unemployment was high, these low-wage employers could count on an ample supply of labor. But it is inevitable that as unemployment is reduced they will encounter stronger competition for labor from higher paying employers. If the past is any guide, the low-paying establishments will solve their labor problems by more extensive hiring among the groups with relatively high unemployment rates—nonwhites and youths—by raising their wages more rapidly than other firms, and by mechanization and more efficient use of their employees.

Job openings in interstate recruitment with the U.S. Employment Service rose sharply at the end of 1965 and were about 65 percent higher than in the same period of 1964, but there were still 224 active job applicants registered with public employment offices for every 100 registered job openings. Pilot surveys of job vacancies in 1965 indicate that, on an over-all basis, available opportunities were still lagging behind the number unemployed. However, the index of help-wanted advertising in 52 cities compiled by the National Industrial Conference Board reached a record high at the end of last year. Our present information system on job vacancies is little more than fragmentary. A comprehensive set of vacancy statistics, comparable to those collected in other countries, would be a most useful tool of analysis.

The further reduction in unemployment expected this year seems likely to follow the 1965 pattern, with perhaps even greater relative gains made by the long-term unemployed, older workers, unskilled workers, and nonwhites. Employment of teenagers can be expected to increase sharply. Additional women may be drawn into the labor force. And migration from agriculture and from depressed areas may accelerate. These are the principal remaining sources of labor for industrial expansion.

The enlistment or conscription of young men into the armed services reduces the supply of civilian labor. By the end of 1966, about 20 percent of the male labor force in the 20–24 year old category will be in the armed services. This represents only a small increase from the 17 percent prevailing figure in 1964, before the current buildup. A relatively large part of the increase in the armed services in 1966 will be in the 16–19 year age group. But with the substantial labor force growth, the percentage of this age group in the armed services by December 1966 should be little different from the 14 percent figure in 1964. The increase in military personnel is expected to total about 300,000 in 1966. This is modest, compared with the Korean war period, when over a million men joined the armed services in 9 months, about 2 million in 2 years.

The current military increases are coming in sectors of the labor force where unemployment rates are high. In December 1965, unemployment among males 20–24 years old was 5.3 percent (unadjusted for seasonality), 1.5 percentage points above the national average for the entire labor force, and unemployment of males in the 16–19 year group was 12.4 percent. In short, men removed from the civilian labor force to go into the armed services are coming from parts of the labor force where they should be more readily replaceable.

Our labor markets will be able to support a large further expansion of the economy. But as production rises and unemployment falls, it will become more difficult for employers to find exactly the right man for each new job. The need for upgrading, for on-the-job training, and other changes in employment practices will become greater. Public and private manpower policies will face their greatest challenge.

As shortages of some skills have begun to develop, programs to train highly skilled people have been intensified under the Manpower Development and Training Act. For example, current activities include an on-the-job training contract with the Chrysler Corporation to train automobile mechanics, and a contract with the National Tool, Die, and Precision Machine Association to double the number of tool and die trainees. Many contracts are presently under negotiation to provide skilled workers for such defense industries as aircraft, ordnance, and electronics. Also, improvement in the Employment Service will help to fill job vacancies.

Active manpower policies are discussed in detail in Chapter 3. They have already contributed importantly to making the labor force better suited for

present job requirements. Their importance will become even greater in 1966.

EMPLOYMENT GOALS

The 1962 Annual Report of the Council specified an interim unemployment target. It was stated that "in the existing economic circumstances, an unemployment rate of about 4 percent is a reasonable and prudent full employment target for stabilization policy. If we move firmly to reduce the impact of structural unemployment, we will be able to move the unemployment target steadily from 4 percent to successively lower rates . . . circumstances may alter the responsiveness of the unemployment rate and the price level to the volume of aggregate demand. Current experience must therefore be the guide." It was made clear that this goal "should be achievable by stabilization policy alone. Other policy measures . . . will help to reduce the goal attainable in the future below the 4-percent figure."

The unemployment rate has now virtually reached the interim target and is projected to fall below 4 percent in 1966. There is strong evidence that the conditions originally set for lowering the target are in fact being met, and that the economy can operate efficiently at lower unemployment rates. The quality of the American labor force has been improving steadily. In 1957, the last year in which unemployment was 4 percent, workers had an average of 11.6 years of schooling; by 1965 they had 12.2 years. Whereas 33 percent of all workers had no more than 8 years of education in 1957, the figure had fallen to 23 percent by 1965. The ease of attaining a given over-all unemployment rate is increased by this higher educational achievement. To be sure, jobs may now require, on the average, more education than they did in 1957. Nevertheless, it is highly significant that, if the unemployment rate for every education group were the same now as it had been in March 1957, the over-all unemployment rate would be 0.4 percentage point lower than it was in 1957.

Partly offsetting the better educational preparation of today's workers is the increasing number of young and relatively inexperienced men and women who now constitute a larger proportion of the labor force than they did in 1957. These workers normally have higher unemployment rates than older, experienced workers. As a result, if every age and sex group in 1965 had the same unemployment rate as in March 1957, the over-all unemployment rate would now be 0.1 percentage point higher than it was in 1957.

The training and manpower policies instituted since 1961 are beginning to reduce the attainable level of unemployment both by raising the employability of workers and by directly altering their labor force status. During 1966, an average of about 300,000 youths will be engaged in special work and training programs. If most of these youths would otherwise have been unemployed, the programs would be reducing the national unemployment rate by about 0.1 to 0.2 percentage point. The absorption of these

workers does not appreciably reduce the supply of labor available for other jobs while they are in training; it does increase their suitability for other employment when their training is completed.

The substantial increase in the number of young men entering military service will have a direct impact on the attainable unemployment rate of civilians. On the assumption that most of the added young men in the armed services in 1966 would otherwise have been in the civilian labor force, but that most of the jobs they would have filled can readily be filled from among the unemployed, the attainable unemployment rate would be lowered by about 0.2 percentage point.

The improved ability of the economy to sustain lower unemployment without inflation arises not only from developments in the labor market. Other factors, which could not be taken into account when the interim target was first set, are equally relevant: the fact that so fine a balance could be maintained between production and capacity—both over-all and by sectors—as the economy moved toward full employment; the higher productivity gains; the increasing keenness of international competition in our markets; the more responsible attitudes displayed by business and labor in wage and price decisions; and the dependability and prudence of consumer and business decisions.

Thus the economic circumstances which accompanied a 4 percent unemployment rate in 1957, or which it was assumed in 1962 would accompany such a rate, now correspond to a lower national unemployment rate. While we will find satisfaction in reaching the interim target, it would be incorrect to identify this accomplishment with full attainment of the goal of an employment opportunity for every American willing and able to work.

Our target should be steady progress, at a pace which permits the economy to adapt to decreasing unemployment rates and growing demand in the product markets. Private and public policies should be able to preserve the reasonable cost and price stability which is necessary for sustainable progress.

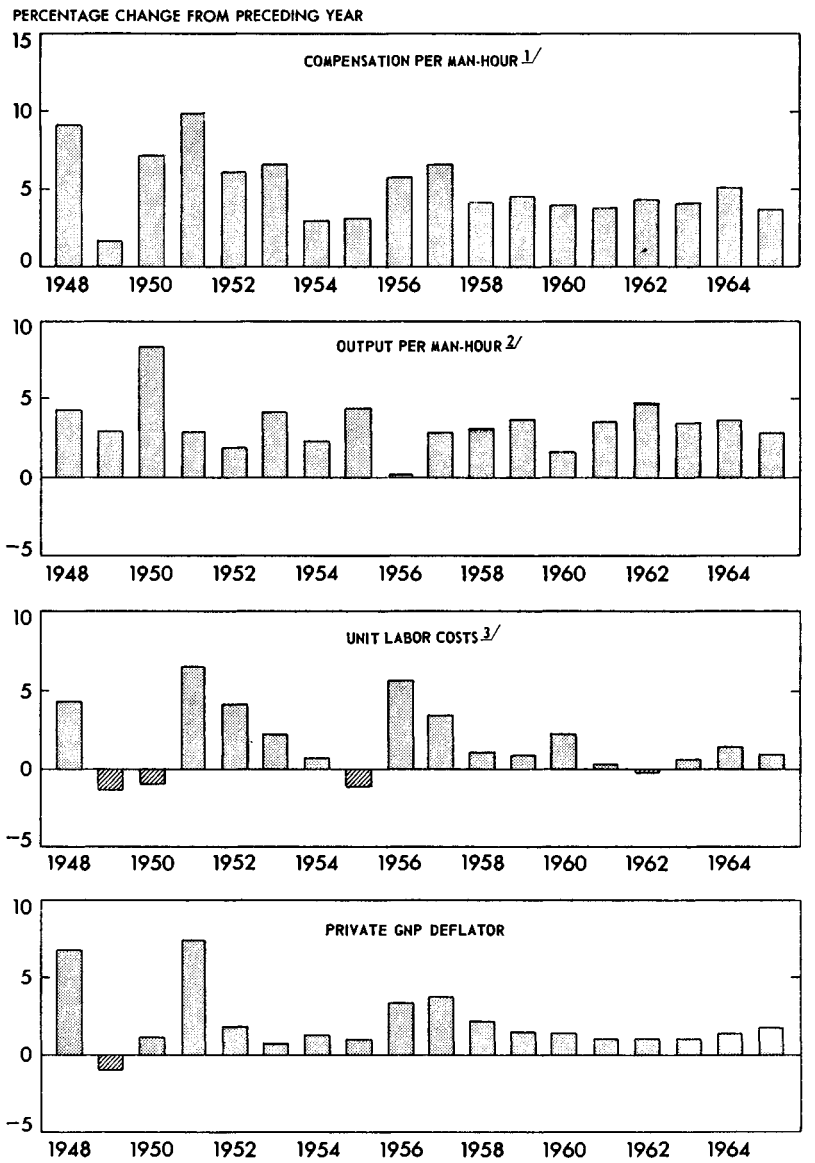
LABOR COST TRENDS

Labor costs per unit of output are an important determinant of over-all cost and price changes. In the postwar period, their widely varying movements have frequently been associated with similar changes in the price level (Chart 10).

Labor costs per unit of output reflect both hourly compensation and output per man-hour or productivity. Increases in compensation raise unit labor costs; increases in productivity lower it. Whether labor costs per unit of output rise during the particular period depends on the relative balance between increase of compensation and of productivity.

Chart 10

Changes in Compensation, Prices, and Productivity in the Private Economy



1/ TOTAL COMPENSATION DIVIDED BY ALL PERSONS MAN-HOURS WORKED.
2/ PRIVATE GNP DIVIDED BY ALL PERSONS MAN-HOURS WORKED.
3/ COMPENSATION PER MAN-HOUR DIVIDED BY OUTPUT PER MAN-HOUR.
SOURCES: DEPARTMENT OF LABOR, DEPARTMENT OF COMMERCE, AND COUNCIL OF ECONOMIC ADVISERS.

Wage movements of recent years must clearly be characterized as moderate. During the first 4 years of the expansion, gross hourly earnings of manufacturing workers rose at an average annual rate of 3.2 percent; corrected for overtime, the annual increase averaged 2.7 percent. Outside of manufacturing, the record is more varied. In mining, gross hourly earnings increased at an average annual rate of only 2.4 percent, and in wholesale trade at a rate of 3.3 percent; but in construction the average yearly increase was 3.8 percent and in retail trade 3.9 percent. When account is taken of increases in fringe benefits, the corresponding figures for total compensation per man-hour would in most cases undoubtedly be somewhat higher. Nevertheless, when combined with the strong yearly gains in productivity, the average increase in total hourly compensation was consistent with relative stability of average unit labor costs throughout the economy.

During the past 12 months, wages have been rising at a pace little different from that of earlier years. Gross hourly earnings of manufacturing workers rose in 1965 by 3.1 percent, and the yearly increase of straight-time earnings was 2.8 percent. In the nonmanufacturing sector, most industries had somewhat larger increases than in the earlier expansion years. Between November 1964 and November 1965, hourly earnings increased by 3.1 percent in mining and in wholesale trade, 4.5 percent in construction, and 5.3 percent in retailing.

The many collective bargaining contracts signed during 1965 were characterized, by and large, by a relative moderation of gains in wages and fringe benefits. In some industries—aerospace, for example—the negotiated increases exceeded somewhat the Council's guideposts for noninflationary wage behavior. But in other industries—steel, rubber, maritime trades, New York newspapers, aluminum—the results of the contracts either fell within or were close to the guidepost standards. The settlement in rubber provided an increase of 3.2 percent, that in aluminum 3.5 percent, and the important steel settlement also 3.2 percent. The pay increase for Federal workers likewise fell within the guideposts. A special Labor Department analysis of the major contracts (those covering 10,000 workers or more) that were concluded during the first 9 months of 1965 indicates that the average yearly wage adjustment resulting from these contracts was 3.3 percent; for contracts covering a period longer than a year, the adjustment was smaller—only 2.7 percent. This analysis considered only wage changes; inclusion of fringe benefits might raise these figures by three-fourths of a percentage point.

In construction, the 1965 contracts—as in previous years—generally resulted in higher wage advances than elsewhere. Between October 1964 and October 1965, union wage scales increased, on the average, by 4.1 percent. Construction is clearly an industry that raises serious problems for wage-price stability.

The generally satisfactory record of 1965 wage contracts has important implications for wage trends in 1966. Many industries have negotiated long-term agreements. The only major industries which will negotiate new contracts in 1966 will be electrical machinery, telephone, and construction; major reopenings could take place in railroads and coal mining. Because of the relatively light calendar of expiring contracts, the basic pattern of wages for most key industries has already been set for 1966.

It is likely, however, that compensation will rise more rapidly in the low-wage and largely nonunionized sectors of the trade and service industries. Many workers at the bottom of the economy's wage structure now face opportunities of moving into more advantageous jobs. Accordingly, wage increases in the low-paid sectors are likely to exceed the average wage rise in the economy as a whole. As indicated by the 5.3 percent increase of hourly earnings in retail trade between late 1964 and late 1965, this has already been occurring.

PRODUCTIVITY AND UNIT LABOR COSTS

A key element in the impressive U.S. record of price stability has been the high rate of productivity advance. Based on tentative figures for 1965, productivity in the private economy (real total private GNP divided by total private man-hours worked) has grown at an average rate of 3.6 percent a year since 1960. Because of these large productivity gains, average annual increases of 4.2 percent in compensation per man-hour have raised average unit labor costs in the private economy by only 0.6 percent a year.

This record contrasts sharply with the experience in the short expansions of the mid-1950's. In the period between the business cycle peaks of 1953 and 1957, unit labor costs increased by 2.1 percent a year; compensation per man-hour rose by 4.6 percent a year while output per man-hour advanced only 2.4 percent a year. In 1956 and 1957, an average annual increase of 4.5 percent in unit labor costs exerted a strong upward push on prices. Between the 1957 and 1960 cyclical peaks, average hourly compensation gains were more moderate—4.2 percent a year—but since productivity was rising at a rate of only 2.7 percent, labor costs were pushed up by 1.4 percent a year.

Manufacturing productivity figures based upon the index of industrial production of the Federal Reserve Board show output per employee man-hour rising by 4.0 percent a year since 1960. Comparing this figure with the 3.6 percent average advance in hourly manufacturing compensation implies that unit labor costs in manufacturing were lower in 1965 than in 1960.

According to preliminary figures for 1965, productivity in the entire private economy increased by about 2.8 percent—below the average for the whole expansion and slightly below the historical average for the entire post-war period. Compensation per man-hour in the private sector rose by 3.7 percent, resulting in an increase of 0.9 percent in unit labor costs. Productivity in manufacturing, based upon the industrial production index,

rose by 3.8 percent and hourly compensation increased by only 3.0 percent. Thus, unit labor costs in manufacturing decreased by 0.8 percent last year.

The good record of productivity during the past 5 years was aided by the sustained expansion of output that has boosted operating rates. As operating rates improve, capital and overhead labor are more effectively utilized. These oversized gains in productivity cannot be expected to continue indefinitely. As preferred operating rates are reached and surpassed, older, less efficient standby equipment must be used, and less-skilled labor must be hired and trained. Partly offsetting this, new and more efficient plant and equipment will be continually coming into use. On balance, therefore, the rate of increase of productivity can be expected to gravitate toward its long-run trend, and the more modest gain in 1965 undoubtedly reflects this.

The exact value of the trend rate of productivity growth—that rate which technological advance, the constantly improving quality of the labor force, and the growing capital stock can sustain—is difficult to ascertain. To isolate the "underlying" trend, adjustments for all short-run factors would be required. But these adjustments cannot be made perfectly. Nor is it likely that the "true" trend would remain precisely constant over time. The factors determining productivity growth have not been and will not be historical constants.

A long-run historical average provides one estimate of the trend rate of productivity growth. The postwar average, from 1947 to 1965, is 3.3 percent. But this may reflect especially favorable factors in the immediate postwar years. On the other hand, the much lower average of 2½ percent for the longer period from 1919 to 1965 is subject to the suspicion that it seriously understates the higher trend in the depression-free postwar period.

The productivity trend can also be estimated from data for the shorter postwar period, using sophisticated statistical techniques to adjust for the short-run factors. Several such techniques have been employed by the Council to obtain the best possible estimate of the postwar trend rate of growth of productivity. While these different methods do not yield identical estimates, for the private sector they fall within the range of 3.0 to 3.3 percent a year.

In 1966, the increase of productivity is expected to continue close to its trend value, though not likely to exceed it. The increase in employer payroll taxes which occurred on January 1 will raise average employment costs this year by about two-thirds of 1 percent. The expected rise in productivity, however, should hold the average increase in unit labor costs to about 1½ percent for the entire private economy. These costs should be approximately stable in manufacturing.

COSTS AND PRICES IN SELECTED PROBLEM AREAS

Some sectors in the economy pose particular problems for the achievement of cost-price stability, either because of especially unfavorable long-

term cost trends or because of potential market imbalances. Five of these areas are examined here: agricultural and food products; nonferrous metals; machinery; construction; and medical services.

FOOD

From 1961 to 1964, consumer food prices rose by only 1.0 percent a year while all other consumer prices were rising by 1.3 percent. But from December 1964 to December 1965, prices of food increased by 3.5 percent while other consumer prices rose by 1.6 percent. The same pattern is even more evident at the wholesale level. Between December 1964 and December 1965, prices of processed food rose by 8.5 percent and of farm products by 11.1 percent. These increases accounted for two-thirds of the total rise in the wholesale price index over this period.

About three-fourths of the rise in retail food prices in 1965 can be attributed to a 13.5 percent advance in meat. There were smaller price increases in poultry, fish, dairy products, and bakery products. On the other hand, prices of fruits and vegetables declined by 3.1 percent during the year, after reaching a peak in the spring.

At the wholesale level, meat prices rose by 29 percent in 1965, in response to a 34 percent rise in livestock prices. Particularly large increases were registered in hog prices, but cattle prices were also up substantially.

These sharp increases were the result of a combination of rapidly growing demand for meat and an unfavorable supply situation. Rising personal incomes and a growing population increase the demand for meat. Supplies, on the other hand, are relatively inelastic in the short run because of the long time period required to expand livestock breeding stocks.

Hog production was reduced during the second half of 1964 and in 1965 as a result of depressed prices received by hog producers in 1963 and 1964. The resultant high pork prices led consumers to switch to poultry and other meats; although beef production increased, supplies were not sufficiently responsive to keep beef prices from rising. Because of the much shorter period required to produce poultry, the supply of broilers responded rapidly to satisfy part of the substantial increases in demand. Thus, poultry prices rose much less than beef or pork prices in 1965—by 7.2 percent in 1965 at the wholesale level and 9.3 percent at the farm.

In the past, hog production has expanded when hog prices were favorable in relation to feed (mostly corn) costs. The hog-corn price ratio has been extremely favorable to producers in recent months. But the increasing importance of nonfeed costs (labor, overhead, etc.) in hog production has made the hog-corn ratio a less reliable indicator of future production. Nevertheless, the evidence indicates that hog producers are now responding to favorable prices; farmers intend to raise 7 percent more pigs during December 1965–May 1966 than they did one year earlier. Thus, while hog prices will probably continue strong throughout the first half of this year, they should begin to decline in the second half when the expanded

spring crop is marketed. Beef production will increase slightly in 1966, but beef prices will probably continue at their high levels through most of the year.

General prosperity was a contributing factor to the rise in food prices in 1965, but supply conditions certainly were the major element. This year should witness a less rapid increase in food prices than was experienced during 1965. Meat prices may rise further in the first half of the year, but some relief is expected in the second half when expanded supplies reach the market. Citrus fruits and fresh vegetables should have lower average prices in 1966 than in 1965 if normal weather prevails. Poultry is also expected to be cheaper.

The rise in farm and food prices has had some limited spillover into the industrial sector. Although the extent of automatic wage escalation with consumer prices is very much reduced from prior years, the wages of about 2 million workers have been raised by the faster rise of consumer prices in 1965.

NONFERROUS METALS

In the last 2 years, consumption of nonferrous metals by U.S. industry has risen substantially. The prices of these primary metals have advanced rapidly, with aluminum ingot up 6.5 percent from December 1963 to December 1965, copper ingot 16.1 percent, pig lead 28.1 percent, pig tin 33.3 percent, and slab zinc 11.1 percent. These increases produced higher prices for fabricated products and were an important factor in the over-all increase of industrial prices.

Earlier in the postwar period, the Government accumulated large stockpiles of a wide variety of materials, including many of the nonferrous metals. Consistent with long-range security objectives, substantial supplies of materials can be made available to help to meet the requirements of the increased military effort and an expanding civilian economy. In the coming year, the availability of the stockpiles should help to prevent a repetition of the imbalances in the markets of certain of these materials that occurred during the last 2 years.

Copper was particularly affected when expanding world demand, coupled with production setbacks resulting from strikes and political troubles in the Republic of the Congo, Zambia, and Chile, caused wide price swings in the secondary markets.

The Government has repeatedly eased pressures by releasing surplus copper from its stockpile. In January 1965, 20,000 tons, and in April 100,000 tons, were released for sale to commercial users. The Mint obtained 30,000 tons in December 1964 and 110,000 tons last October from the stockpile for its coinage needs. After price increases in October by major foreign producers, the President announced a 4-point program, including the release of an additional 200,000 tons of copper from the stockpile; controls on the

export of copper scrap; removal of the 1.7 cent tariff on imported copper; and a request to the Commodity Exchange of New York to raise margin requirements to curb speculative trading in copper futures. In January of this year, export controls were extended to virtually all copper and copper products.

The outlook for copper remains highly uncertain because of political factors abroad. Government policy will continue to strive to maintain supplies adequate for rising military and civilian demands.

Domestic production of lead and zinc has recently been insufficient to satisfy high demands, and surplus metal was released from the stockpile at the request of the industry. Further, the President, on the recommendation of the Tariff Commission, revoked the import quotas which had been instituted during a period of excess supply in 1958. No imbalances are expected in 1966.

The demand for aluminum rose rapidly in 1964 and 1965. Defense requirements will continue to increase in 1966, to between 300,000 and 400,000 tons a year—double the requirements before the increased military activities in Vietnam. The industry has been operating close to capacity but supplies have been augmented by a rising flow of imports. Ingot prices began to rise in late 1963. Announcements of further price increases were made by producers in October 1965.

To help to restore balance in the market for primary aluminum, the Federal Government intensified negotiations for the orderly release of the 1.4 million ton stockpile of aluminum in excess of emergency needs. Agreement was reached with the industry, calling for sale to the industry of a minimum of 100,000 tons of aluminum a year for 10 to 12 years; in the event that added defense requirements exceed this level, additional releases can be made up to a maximum of 200,000 tons a year. This release will assure continued availability of sufficient amounts of aluminum and should preserve balance between production and demand in the market at stable prices.

MACHINERY

In the inflation of the mid-1950's, higher machinery prices played an important part in raising the wholesale price index. The index for electrical machinery increased by 16.2 percent between 1955 and 1957, construction machinery by 16.6 percent. This year will again see heavy investment spending, and the possibility of similar machinery price increases must be examined.

In December 1965, the wholesale price index of nonelectrical machinery was 11.9 percent above the 1957–59 average. In the last year, prices rose by 1.8 percent, compared with an average annual increase of 1½ percent in the preceding 6 years. Some of these increases probably reflect an improved product, not fully adjusted for in the index. But prices have also reflected sharply rising demands, expanding profit margins, and some increases in costs.

Trends of wage rates and material costs for the industry have been moderate in the past few years. Gross average hourly earnings advanced at an average rate of 3.0 percent a year from 1960 to 1964. In 1965 they were up 2.8 percent, partly reflecting the greater use of overtime. The Federal Reserve Board's index of industrial materials prices rose by more than 1.0 percent in 1965, after 4 years of relative stability. The price of steel, a major input, rose little, in sharp contrast to the 1950's.

Profits in 1965 were appreciably above 1964. Industry profits in nonelectrical machinery in the first 3 quarters were 23 percent higher than a year earlier, to yield a 14 percent after tax return on equity.

Avoiding bottlenecks in the machinery industry depends on the expansion of capacity to meet rising demands and on the availability of skilled labor. The last 5 years have seen a steady rise in the output of machinery. In 1960, production of nonelectrical machinery was at a rate equal to 70 percent of industry capacity. Modest output increases in the next 2 years raised operating rates to 79 percent of capacity by the end of 1962. Output spurted by 12 percent in 1964, reflecting the large rise in investment expenditures, bringing the industry's operating rate to 87 percent by the end of the year. Another 12 percent gain in output occurred in 1965, as business investment rose once more, higher farm income raised sales of agricultural machinery, and defense needs called for increasing amounts of construction machinery. During the year, the nonelectrical machinery industry operated at about 88 percent of capacity, still 3 percentage points below the preferred rate. The industry's own anticipated spending on plant and equipment promises to raise its capacity about 8 percent in 1966. Thus, while utilization rates may rise, no general pressure on productive capacity is currently foreseen. Some limited segments of the industry will be straining capacity, however.

The backlog of unfilled orders for nonelectrical machinery has been relatively steady during the expansion, rising gradually from 2.6 months of shipments in 1963 to 2.8 months in 1964 and 3.2 months in November 1965. In the sensitive machine tools sector of metalworking machinery, the backlog of unfilled orders was 7.7 months in October for metal cutting tools, up from 6.8 months a year earlier. For metal forming tools, however, the backlog fell to 10.2 months, from 11.1 a year earlier. Given current operating rates, these backlogs are not unduly large.

In 1965, the industry expanded its employment by 7.0 percent, training many new workers to fill its enlarged requirements. This year, another large employment increase will be necessary, and even more new workers will have to be trained through private and public efforts.

In summary, increased nonelectrical machinery production should be able to provide the equipment needed by an expanding economy. The industry may have some difficulty finding enough skilled labor. But given the expected trends in costs, and the apparent availability of adequate physical

capacity, the large price increases which disturbed investment in the mid-1950's are not likely to recur this year.

The electrical segment of the machinery industry maintained stable prices in 1965. Prices were no higher than in 1964, and indeed were 3.2 percent below the 1957–59 average. Capacity in this industry has been ample, costs have been stable, and competition, including that from abroad, has been keen. These factors will continue to support price stability in 1966. The wage negotiations this October will affect cost trends in the future.

CONSTRUCTION

Construction is one of our largest industries. In 1965, it employed more than 4 million workers. Construction prices and wages have been rising more rapidly than in most other sectors of the economy. Between 1960 and 1965, price indexes of finished construction rose by 2.2 percent a year on the average. Over the same period, both average hourly earnings and union wage rates of construction workers were rising at an annual rate of 3.8 percent. Larger fringe benefits probably bring the increase in total hourly compensation a fraction of a percentage point higher.

Higher prices have reflected both substantial increases in employment costs and some possible widening of profit margins. Wholesale prices of construction materials have been relatively stable during most of the expansion. While estimates of labor productivity in construction are highly imperfect, they nevertheless suggest that the annual increase in output per man-hour is below the economy-wide average, and substantially below the annual increase in employee compensation.

During the past year, the rise in construction prices has accelerated. The increase in the GNP deflator in 1965 was 2.9 percent for total construction, 2.7 percent for nonresidential construction, and 3.3 percent for private residential construction. The rise for residential building is particularly disturbing in view of the fact that there has been no increase of activity in this sector for several years.

The rate of wage increase in construction has also accelerated. Between October 1964 and October 1965, the average increase in union rates of construction workers was 4.1 percent; and average hourly earnings increased during the year by 4.5 percent. Moreover, many of the construction contracts signed last year provided relatively large deferred compensation increases in 1966 and 1967. Again this year, construction costs and prices are expected to rise more rapidly than the over-all GNP deflator.

The inflationary cost and price situations in the industry reflect to some extent its prosperity, especially in its industrial and commercial sectors. They also suggest the existence of more permanent structural problems which should be of vital concern for both the industry and the community

at large. There have been many important technological changes in various sectors of the industry, but the total technical progress is clearly insufficient.

Ways must also be found to expand more quickly the supply of skilled construction labor. Restrictions on entry not only retard the growth of the industry but also have adverse social effects, since they tend to keep Negro youths out of attractive types of employment. To meet the needs of rapid growth and equality, vocational programs for skilled craftsmen must be stepped up.

There is need for institutional arrangements that will increase the geographical mobility of skilled workers. Labor mobility in construction has been reduced by the spread of locally instituted welfare and pension plans whose benefits are not "portable" from one area to another. Development of national pension and health and welfare programs as well as broader vesting and interarea portability of rights and benefits will contribute to greater mobility and more efficient utilization of the present supply of construction workers.

MEDICAL SERVICES

Persistently and strongly rising fees and charges for medical services have exerted an upward influence on the consumer price index throughout the postwar period. As shown in Table 13, medical care prices, which account

TABLE 13.—*Changes in consumer prices for medical care, 1947–65*

Period	Annual percentage change in consumer prices			
	Medical care			All other items
	Total	Medical services	Prescriptions and drugs	
1947 to 1953	4.2	4.6	2.1	3.0
1953 to 1960	3.7	4.0	1.7	1.3
1960 to 1965	2.5	3.1	−.8	1.2
1960 to 1961	3.0	3.7	−1.2	.9
1961 to 1962	2.6	3.3	−1.5	1.1
1962 to 1963	2.5	3.0	−.9	1.1
1963 to 1964	2.1	2.4	−.3	1.4
1964 to 1965	2.4	3.2	−.3	1.5

Source: Department of Labor.

for about 6 percent of consumer expenditures, have risen twice as rapidly as the average of all other consumer prices for most of the postwar period, and have contributed one-tenth to two-tenths of 1 percent to the rise of the index in most years.

In the most recent 5 years, medical costs have risen less rapidly than during the 1950's. This has been due primarily to the fact that prices of prescriptions and drugs have been declining. Also, the increase in charges for medical services—including doctors' and dentists' fees, eye examinations and

eyeglasses, and hospital rates—has slowed down in comparison with the earlier period.

The higher hospital and doctor charges reflected in the consumer price index may overstate the true increase in the cost of medical care when account is taken of the rising effectiveness of the care received. With the dramatic improvements in medical technology that have taken place over the postwar period, many patients get more real "services" from each day's stay in the hospital, or each visit to the doctor, than before.

The basic sources of rising medical costs are the inadequate supply of personnel and facilities, the sharply rising cost of hospital construction and of continually more complex medical equipment, the rapid increase in salaries of medical personnel relative to productivity gains as presently measured, and the expanding demand for medical services. Although some of these conditions may be relieved in the longer run, they will not be in the immediate future. The advent of Medicare will add to the expanding demand for medical services and facilities. Thus, the urgency of public policies to augment medical care resources and to improve their organization for efficient use will be even greater.

OUTLOOK FOR COST-PRICE STABILITY IN 1966

The above review shows that the economy is making a good adjustment to the altered economic environment. With the unemployment rate at 4.1 percent and clearly moving downward, there is strong evidence that the substantial inflation of industrial prices experienced in the mid-1950's is not recurring.

The outlook for unit labor costs is good. Although a few individual settlements may be out of line, the general advance of wages should not accelerate this year, and productivity can be expected to remain close to the trend rate. So long as costs do not move up substantially, price changes will remain limited.

Producers are generally able to meet rising orders out of growing capacity and to find the labor needed for expanding production. Competition remains keen, and imports are limiting price advances in several key sectors. There are occasional examples of shortsighted pricing policies on the part of a few firms, and there will probably be more. But most industries have learned to fear the fool's paradise of rising prices that produce unsustainable profits, shrinking markets, and permanently higher labor costs.

With the economy now approaching full utilization of its resources, the risk of price increases becomes greater. Occasional disturbances to the supply of some key commodities are likely to occur, although their specific form cannot be foreseen. The ability of employers to redesign jobs and train additional skilled workers may not fully match the rising demands for skilled labor in all industries.

But so long as labor costs remain generally stable, difficulties in obtaining materials remain isolated, consumers and businesses retain moderate expectations, and key decisionmakers continue to respect the public interest in setting wages and prices, the prospects are excellent that the recent generally good record of costs and prices will continue.

GUIDEPOSTS FOR NONINFLATIONARY PRICE AND WAGE BEHAVIOR

Most earlier periods of high employment since World War II have been accompanied by inflation. In some of those years, the cause clearly was excessive demand. In other years, no general excess of demand was evident, yet prices continued to creep upward. The movement continued even during some periods in which—on any reasonable criterion—over-all demand was quite inadequate. The exact diagnosis remains a matter of some disagreement among economists. But almost all agree that an important part of the explanation lies in the fact that, in many industries, unions or managements or both possess considerable discretionary power to set wages and prices, and that in too many instances they have used that power to raise wages and prices in ways not consistent with basic supply and demand forces in the market.

The apparent "inflationary bias" in our wage-making and price-making institutions has been of almost continuous concern for the Council of Economic Advisers for many years. Appeals for responsibility and moderation—for taking the public interest into account in wage and price decisions—have had a perennial place in successive Economic Reports. In its Annual Report of January 1962, the Council for the first time attempted to provide private decisionmakers with rather more specific standards for judging whether their decisions were responsible and took adequate account of the public interest. These standards or "guideposts" were also designed to permit the public to reach its own conclusions concerning the degree of responsibility exercised by leaders of business and labor.

INCREASING IMPORTANCE OF THE GUIDEPOSTS

In the years since 1962, the guideposts have gained increasing significance. The slow and difficult progress in restoring equilibrium in our international balance of payments has underlined the necessity that American goods retain or improve their competitive position in export markets and in our own market. Our goal of balance of payments equilibrium in 1966 and thereafter will permit no retreat from cost-price stability.

During the recent years of still excessive unemployment and idle capacity, strong competition for jobs and markets reinforced a growing sense of responsibility on the part of labor and management. The fuller use of resources achieved last year and be excellent prospects for 1966 may reduce

that reinforcement. We now confront the task of reconciling full employment with stable prices.

The record reviewed in previous sections of this chapter makes it clear that the overwhelming majority of private wage and price decisions in recent years has been consistent with the guideposts, whatever the extent to which the guideposts may have consciously entered into the decisions reached. It is clear, however, that in many instances the guideposts have consciously affected these decisions. On numerous occasions, Government officials have specifically reminded unions or managements of the guidepost standards—either publicly or privately, either generally or with reference to specific situations. Several of the more important of these situations have attracted considerable public attention.

In January 1965, the President requested the Council of Economic Advisers to prepare an analysis of steel prices, following certain increases in such prices and at a time when important wage negotiations were pending. The Report, made public in early May, analyzed the position of the industry and the factors affecting it. It showed that wage and price decisions consistent with the guideposts would be in the interest of both labor and management and of the Nation. Later, the Government helped the two parties to reach a peaceful settlement in the steel wage negotiations. A damaging strike was avoided, and a settlement was achieved within the wage guideposts. According to the best estimates of its cost available to the Government, the settlement averaged 3.2 percent a year, computed over the full 39-month period.

Following the labor settlement, prices on tin plate were raised in October; this was accompanied by a price reduction on a new black plate, which is expected to substitute increasingly for tin plate in many uses. At the year's end, the Bethlehem Steel Company announced a $5 a ton increase on structural steel and pilings. The Council pointed out that such an increase was not justified under the guideposts. In January, the U.S. Steel Corporation announced a smaller increase, accompanying it with price reductions on other steel products.

In October, the Council prepared a guidepost analysis of price increases initiated by producers of primary aluminum; the companies later rescinded these increases.

Also in October, the President, by threatening a veto, persuaded the Congress to enact a pay increase for civil service and postal employees of the Federal Government which was within the guideposts.

These actions and many others clearly reaffirmed the Administration's strong commitment to the guideposts as an essential pillar for price stability.

THE GUIDEPOSTS RESTATED

1. The general guidepost for wages is that the *annual rate of increase of total employee compensation (wages and fringe benefits) per man-hour worked should equal the national trend rate of increase in output per man-hour.*

2. The general guidepost for prices is that *prices should remain stable in those industries where the increase of productivity equals the national trend; that prices can appropriately rise in those industries where the increase of productivity is smaller than the national trend; and that prices should fall in those industries where the increase of productivity exceeds the national trend.*

Within a given industry, the guideposts allow for individual wage and price adjustments that do not affect the over-all wage or price level of the industry. Increases for some groups of workers or products can be balanced by reductions for others.

Observance of the guideposts would mean that unit labor costs would decline in the industries where productivity gains are above average, and rise in industries where such gains are below the national average. Average unit labor cost in the economy would remain constant. Similarly, the decrease of prices in industries with above-average increases in productivity would offset the price rises in industries with below-average productivity gains. The average level of prices would remain stable.

Adherence to the standards would mean that *all* the participants in the productive processes—employees and owners of invested capital—would share in the over-all gains in productivity created by the growth of capital equipment, improved technology, and a better educated, healthier, and more skilled labor force. This can readily be seen from a simple example. Suppose output in an industry is 1 million units, each selling at $1, for total sales of $1 million. Suppose labor compensation is $600,000. If productivity and wages both rise 3 percent, and employment remains unchanged, production will expand to 1,030,000 units, which, at $1 a unit would raise revenues to $1,030,000. Labor compensation would rise to $618,000. Labor would thus receive 60 percent of the added value, keeping unchanged the share of labor costs in total revenues. If prices of materials and other purchased inputs were unchanged, and the quantities used were expanded in proportion to output, then gross income of owners would rise in the same proportion as wage income. Thus, the division of income between labor and capital would remain unchanged. And with capital requirements per unit of output unchanged (as has been approximately true), the return per unit of capital would remain unchanged as well.

The actual sharing of gross corporate income between labor and capital has remained virtually unchanged since World War II. There have been repeated short-run swings, with labor's share rising in recession and falling during expansion. Thus, for example, the share of nonwage income rose from 27.2 percent in 1961 to 29.2 percent in 1965. This recent figure is virtually identical with the division of income in 1955 and 1948. The inflationary wage-price spirals of the 1940's and 1950's did not, in fact, change the distribution of income.

Public policy is and should remain neutral with respect to wage and price decisions that attempt to change the distribution of industry's income between labor and capital. But when such decisions lead to inflationary pressure, they properly become a subject of public concern.

EXCEPTIONS TO THE GENERAL GUIDEPOSTS

Some exceptions to the general guideposts are necessary to promote economic objectives. Wage increases above the general guideposts may be desirable

—where wage rates are inadequate for an industry to attract its share of the labor force necessary to meet the demands for its products;

—where wages are particularly low—that is, near the bottom of the economy's wage scales; or

—where changes in work rules create large gains in productivity and substantial human costs requiring special adjustment of compensation.

Because the industries in which unions possess strong market power are largely high-wage industries in which job opportunities are relatively very attractive, the first two of these exceptions are rarely applicable.

On the price side, increases in price above the general guidepost standard may occasionally be appropriate

—to reflect increases in unit material costs, to the extent that such increases are not offset by decreases in other costs and significantly impair gross profit margins on the relevant range of products, or

—to correct an inability to attract needed capital.

The large firms to which guideposts are primarily addressed typically have ready access to sources of capital; moreover, the profits of virtually every industry have risen sharply and are at record levels as a byproduct of the general prosperity in the economy. The second exception is thus not widely applicable in the present environment.

SHORT-RUN AND TREND ELEMENTS IN PRODUCTIVITY AND THE GENERAL WAGE GUIDEPOSTS

In the original discussion of the guideposts in the Council's Annual Report of 1962, it was pointed out that, "it is desirable to segregate the trend movements in productivity from those that reflect business-cycle forces." During the last 5 years, the economy has been closing a substantial gap between actual and potential production. This has augmented the yearly productivity gain beyond the long-term sustainable trend. Now that the economy has little gap remaining to close, the trend of productivity gains will be determined only by capital investment, an improving labor force, and technological progress. The temporarily high productivity gains that come from utilizing equipment and manpower more efficiently through higher operating rates are largely behind us.

To assure future stability of unit labor costs, wages should increase no faster than the sustainable trend of productivity.

The original formulation of the guideposts did not specify any particular trend productivity figure, but rather listed various historical averages, covering different time spans and various segments of the economy. Since the economy was just recovering from the second of two recessions in a very short interval, it was difficult to identify the trend productivity rate from the immediately preceding experience. This difficulty was compounded by speculation that the trend rate might be accelerating as a result of faster technological change, particularly the spread of automation.

In the Report of 1964, no single figure for trend productivity was specified, but in a related table the now well-known 3.2 percent appeared as the latest figure in a column labelled "Trend productivity." The figures in that column were described as the "annual average percentage change in output per man-hour during the latest 5 years." A 5-year period was chosen because, at that time, it was sufficiently long to include both the extraordinarily high productivity gains of a year of recovery (1962) and the extraordinarily low productivity gains of a year of recession (1960). Under the conditions of 1964, a 5-year average gave a good approximation of the trend productivity, because, in effect, it averaged out the ups and downs of cyclical productivity swings. These same conditions prevailed in 1964, and the 3.2 percent figure appeared for that year in a similar table in the 1965 Report. Subsequent revisions of GNP data would have made the 5-year average 3.4 percent in both 1964 and 1965.

Now that the economy is at the end of its fifth year of uninterrupted expansion, a 5-year average no longer gives a reasonable approximation of the true productivity trend. The last recession year drops out of the average, yet the unsustainable productivity gains of a year of recovery and 4 years of improving utilization are retained. If use of the 5-year average were continued this year and in coming years, the figure yielded by the 5-year moving average would rise at this time to 3.6 percent and would undoubtedly fall substantially thereafter.

An analysis of recent productivity movements was presented earlier in this chapter. It is clear from this analysis that 3.6 percent would not be an accurate measure of the true trend of productivity. Rather, it appears that the long-term trend, independent of cyclical swings, is slightly over 3 percent.

For 1966, the Council specifically recommends that the general guidepost for wages of 3.2 percent a year be continued. We make this recommendation in the light of the following additional considerations:

(1) With the economy approaching full employment and the crucial test of our ability to reconcile our employment and our cost-price goals at hand, it would be inappropriate to raise the guidepost.

(2) The actual productivity gain that can be expected over the next few years is not likely to be above the trend value.

(3) The 3.2 percent rate has been consistent with the approximate stability of industrial wholesale prices which has strengthened our competitive position in the world. Now is not the time to abandon that standard.

(4) On January 1, employer payroll taxes to finance social security and Medicare rose substantially, raising labor costs per hour by an average of two-thirds of a percent. These taxes are not included in the definition of employee compensation for purposes of the guideposts, since the rates and the benefits are determined by law rather than by collective bargaining. Nonetheless, recognition has to be taken of the extraordinary increase in these taxes at this time, which will both raise unit labor costs and yield future benefits to employees.

GUIDEPOST POLICY ON PRICES

The guideposts must continue to aim at complete stability of average domestic prices. While individual prices will rise from time to time, others must fall if upward pressure on the general price level is to be avoided. To achieve that goal in a fully employed economy will require that unions refrain from insistence on irresponsible wage settlements, and an even greater willingness by management to take the public interest fully into account in its pricing decisions. Every management with some market power must ask itself: Is a price increase justified by increases in costs? Or is it an attempt to take advantage of prosperity to widen profit margins? Those companies that incur rising costs for materials or purchased services must see if these cannot be absorbed from lowered costs elsewhere in their operations. And those companies with exceptionally favorable productivity gains must consider whether this is the time to seek to keep the gains in the form of still higher profits, or whether to share them with consumers through lower prices. Unions which are in a favorable bargaining situation must remember that wage increases that force employers to raise prices will be paid for by the workers in other industries.

Both unions and managements should reflect on the fact that if their actions create an inflationary spiral, the most likely outcome will be restrictive fiscal and monetary policies which will aim to stop further price increases but will in the process also reduce output, cut back profits, and reduce employment.