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IDEOLOGY AND INFLATION
Implications of Price and Wage Trends for National Stabilization Policies

Remarks By

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The central question confronting monetary policy today is the future course of fiscal policy. If the revenue and expenditure program which the President recently recommended to Congress is enacted in a timely fashion, it would undoubtedly result in a better mix of public policies conducive to achieving and maintaining stable economic growth without inflation. Through reducing the size of the Federal deficit, it would lessen the Government's need to borrow. It would thus simultaneously ease pressures on the capital market and interest rates, some of which are essentially back to the historic levels reached in 1966 -- despite the liberal provision of bank reserves this year.

In recommending the enactment of a 10 per cent surtax on personal and corporate incomes, the President stressed four urgent objectives:

- The reduction in the deficit in the Federal Government's budget, which under the impact of Vietnam spending may exceed $25 billion in fiscal 1968 without the tax increase.
- The lessening of capital market congestion and pressure on interest rates.
- The avoidance of renewed inflation and the maintenance of balanced economic growth, and
- Improvement in our balance of international payments.

These objectives are obviously of vital concern to the Federal Reserve System -- and particularly the last three which fall directly in the area of the central banks' traditional responsibility. In fact, all seven members of the Federal Reserve Board joined in a public statement endorsing the proposed surtax when it was announced on August 3. As the Congress proceeds with its examination of the President's proposal, I am certain the Board will have an opportunity to present its views both officially and comprehensively.

In the meantime, I would like to explore two aspects of the case for enactment of the surtax: the need to avoid renewed domestic inflation and the need to make further progress in our balance of payments. My theme can be summarized quite briefly:

- The slowdown in economic growth associated with the inventory adjustment earlier this year is about over. The pace of activity is again quickening, and left unrestrained private spending would combine with Government expenditures (especially for the Vietnam war) to generate another round of excess demand for goods and services.

- Inflationary pressures, which lessened appreciably in the first half of this year, are again stirring as expanding demand provides an environment hospitable to price increases.

- Because of the sharp increase in labor cost in relation to output in the last year, some price rises probably cannot be avoided during the rest of 1967.

- However, this is by no means true for 1968. While profit margins have shrunk this year, they still remain high by historical standards. Consequently, we as a nation should not tolerate a spiral of price increases on into next year aimed at restoring profit margins to the record level established in early 1966.

- We also need a viable means of moderating the rise in wages and other forms of labor compensation. While we can understand the frustrations of wage earners whose real incomes have been shaved by the substantial increases in the cost of living in the last few years, we should not permit such sympathy to divert our attention from the fact that excessive wage increases are also inflationary.

- Domestic price stability is a crucial ingredient in our long-run efforts to expand our trade surplus as the principal means of erasing the deficit in our balance of payments. However, in the last two years, prices in the United States seem to have advanced more than prices in most other industrial countries. Renewed inflation in the U.S. would further worsen our international competitive position and would make it even more difficult to improve our balance of payments.

- While the dampening effect of the proposed surtax on inflationary pressures cannot be estimated with any precision, a rough calculation suggests that it would have a significant impact on the general price level.

Quickening of Economic Activity

Almost daily, another set of statistical indicators brings additional confirmation of the quickening pace of economic activity. I naturally must refrain from attempting to forecast the future course of the economy. On the other hand, I cannot avoid concluding from the unfolding evidence that the forces which retarded the economy earlier this year are now giving way to the forces of renewed expansion. From the earliest stage of production to the counters of final demand, more-and-more indicators point toward a vigorous advance -- while virtually none suggest continued sluggishness.

Manufacturers' new orders for durable goods, a fairly reliable indicator of future production activity, rose further in June, with the gain centering in the durable goods sector. In fact, orders for hard goods have recovered over half of the earlier decline (which was about 13 per cent) from the peak set last September. Unfilled orders registered a further modest gain in June and July. Industrial production advanced by 1 percentage point in July, after declining during five of the preceding six months. The civilian labor force (which increased rather slowly for several months) has regained its momentum, rising by 250,000 in July. Nevertheless, nonfarm employment climbed by 200,000 in July, lifting the employment level by almost a half million workers above its recent low point in May. Also in

July, the unemployment rate drifted downward to 3.9 per cent. While employers still seem interested in restricting over-time, the average number of hours worked at straight-time in manufacturing did rise moderately in July.

With quickening activity, personal income rose by $4.5 billion in July, following a rise of $4.4 billion in June. At a seasonally adjusted annual rate of $627 billion, personal income is running 7 per cent above its year-ago level. Through the second quarter of this year, after-tax personal income had gained almost 7½ per cent compared with the level in the same quarter of 1966. Sustained by the strong advances in disposable income, consumer expenditures have also been expanding briskly, registering a gain of 2 per cent in June. In the durable goods sector, sales of domestically-produced automobiles in July were maintained at the annual rate of 8.4 million units to which they had risen in June. Sales of soft goods also accelerated in June to reach a new peak and were maintained in July. With the steady growth of employment, additional wage increases in the private sector and a projected pay raise for Federal employees and military personnel, expanding consumer expenditures seem almost certain to provide a strong underpinning for further growth in economic activity during the balance of this year. Such outlays may well receive an additional boost if the exceptionally high savings rate continues to decline (from 7.3 per cent in the first quarter and 6.7 per cent in the second) toward the more normal level of just under 6 per cent which it averaged in 1965-66.

While the foregoing indications are clear signs of revival in economic activity, the most striking evidence is found in the pace of the inventory adjustment. In the fourth quarter of last year, nonfarm business inventories were being accumulated at an annual rate of $18.5 billion. By the first quarter, the rate had declined to $7.1 billion, and it dropped further to only $0.5 billion in the second quarter. Thus, from adding $18 billion at an annual rate to the demand for output in the closing months of last year -- as inflationary expectations induced businessmen to rush to add to their stocks -- nonfarm inventories swung around drastically to the position of subtracting roughly the same amount from output six months later. Because of this serious drag on activity, GNP rose by only $13 billion, or 1.7 per cent, during the first half of this year. Sales to final users, however, climbed by $31 billion, or 4 per cent, in the same period. Because of this rapid pace of inventory adjustment, many businessmen may have brought their stocks fairly well into line with sales -- although some further reduction in the rate of inventory investment may occur over the next few months. Consequently, even if the growth of final sales were simply to hold to the average increase of $15 billion per quarter registered so far this year, it seems obvious that the economy has passed successfully through the period of inventory adjustment and is now headed into a period of strong expansion.

Construction activity also appears to be adding strength to the quickening pace of business. In the second quarter, residential construction expenditures were $2.2 billion(or 10.5 per cent) higher than in the fourth quarter of last year when the recent low was reached.

A further advance in spending for private dwellings accounted for part of the estimated increase in total construction expenditures. While housing starts edged down somewhat in June, they rose sharply in July to an annual rate close to 1.4 million units. The present quarter still seems likely to register further increases -- reflecting the continued moderate uptrend in building permits, the unusually low current level of vacancies, and the build-up in mortgage commitments outstanding.

With the turnaround in industrial production last month and prospects for additional gains in the months ahead, the downtrend in the rate of capacity utilization in manufacturing appears to have ceased. This rate fell from 91 per cent last August to 84 per cent in July. Only in a few industries (particularly aircraft and electrical generating equipment) does pressure on capacity continue to be felt. In most industries capacity is continuing to grow at a rapid pace, despite the relatively low rate of utilization. Furthermore, partly reflecting the restoration of the investment tax credit, the outlook for business fixed investment appears to be brightening. In recent months, new orders for machinery have advanced steadily, and order backlogs have risen. Moreover in July both output and employment in machinery industries turned up.

To me, all of the above indicators suggest strongly that the most likely course of economic activity in the months ahead is one of growing strength -- and not accumulating weakness.

The Mosiac of Price Developments

In this environment of improving economic conditions, price increases are becoming more-and-more wide-spread. While these increases do not by any means add up to a new outbreak of inflation, the current stirrings on the price front are unmistakable harbingers of the pressures that can develop as aggregate demand expands more vigorously. Moreover, the cumulative impact of particular -- though increasingly numerous -- price advances may be the stimulation of an inflationary psychology which would feed on itself and help to trigger a genuine bout of inflation.

Industrial wholesale prices: One of the striking developments over the last year has been the marked slowing of the rise in the BLS wholesale price index for industrial commodities, which is generally more sensitive to business conditions than other price indexes. In June, this index was 1 per cent above June, 1966, and in mid-July it was up less than 1 per cent from a year earlier. In contrast, from mid-1965 to mid-1966, it had increased about 2.5 per cent; and during a nine-month period in late 1965 and early 1966, it had increased at an annual rate of 3 per cent.

Moreover, the rise over the last year in average industrial prices had occurred by last February. From February through early July, the BLS index was stable.

The shift to a much smaller advance over the last year -- and stability this spring and early summer -- reflected in large part the reversal of the earlier sharp climb in prices of sensitive industrial materials (including nonferrous metals, hides, and lumber) which had begun in 1964 and continued to mid-1966. The sharp drop in prices for most of these materials over the last year can be traced in some cases to marked improvement in domestic and world supplies; slackening in demands abroad as a result of slower economic activity in major European countries, and slackening housing and consumer and business demands at home. Price increases for other non-sensitive materials have also slowed since mid-1966, and particularly since early 1967. Moreover -- although producers' equipment prices increased more (3.2 per cent) from mid-1966 to mid-1967 than over the preceding twelve-month period (2.4 per cent), these prices were accelerating during 1966 when they increased at the rate of 4-5 per cent a year. Since the end of 1966, when business fixed investment demands eased noticeably, equipment prices have increased at an annual rate of only 2 per cent. Wholesale prices of finished consumer goods (other than food) increased as much from mid-1966 to mid-1967 as over the preceding year, but (as in the case of producers' equipment) the rate of increase has been slower in recent months.

Outlook for industrial prices: The slowing of the rise in wholesale prices of industrial commodities from mid-1966 to mid-1967, and particularly during the first half of this year, has been predominantly a demand phenomenon. Of course, as noted above, the drop in sensitive industrial materials was partly a supply development, and lower prices of these basic industrial materials have represented a reduction in materials cost for fabricators. In general, however, cost pressures have remained strong, and profit margins have been under pressure.

It appears likely that average industrial (wholesale) prices are now starting to increase again, partly because of continuing pressures from rising unit labor costs supplemented by the first significant boost in transportation/costs

in
/seven years. Since early July, substantial price advances have been effected for tires and other rubber products following the large wage settlement which ended a 3-month strike. Growing strength in housing has been accompanied by a wide array of price increases -- for lumber, plywood, flat glass, gypsum products, and hardware and heating equipment. Uncertainty over the course of the current strike has brought some recovery in secondary copper and copper products, despite a still generally ample supply situation. The current copper strike (as the rubber strike) is acting to work off excessive stocks and -- depending on the size of the wage settlement (which may be large) and on continuing increase in domestic demands -- an increase in the domestic producer price of refined copper may be in the offing.

Metals demand -- and prices -- generally were affected by the easing off in business equipment and consumer durable goods production, as well as by the slack in housing. Recovery in durable goods production, now anticipated during the last half of this year, may well lead to metal price advances and to some acceleration in price increases for finished metal products. The steel industry, noting a recent improvement in demands, as well as higher labor and transportation costs, has recently announced price increases for tin plate and steel plate. Moreover, major truck producers have announced higher list prices for 1968 models.

Recent price increases in a number of cases undoubtedly reflect a testing of markets and efforts to relieve some of the growing cost pressures of the last year. In general, however, most markets remain quite competitive, with import competition an important factor. As indicated above, rates of capacity utilization are relatively low (by 1965-1966 standards) in all but a few major manufacturing industries.

Altogether, a situation is clearly developing which promises increases in average prices of industrial commodities over the coming months. But it is not evident, yet, that the increases will be excessive in the short-run. One important factor to note is this: if demands and industrial production should increase more rapidly than now seems probable (while this would provide a congenial setting for accelerating price increases), a marked rise in industrial production would undoubtedly be accompanied by renewed large advances in productivity and a concomitant easing of upward pressure on unit labor costs. Another factor influencing the future course of prices will be the coming on stream of much new and more efficient capacity.

<u>Wholesale prices of farm products and foods</u>: The reversal, between September 1966, and April 1967, of the earlier sharp rise in agricultural prices caused an actual decline in the total BLS wholesale price index -- from 106.8 per cent of the 1957-59 average in September to 105.3 per cent in April. With agricultural prices down over the year (and the rise in industrial commodities much slower), the total wholesale

price index in June was only 0.6 per cent above June 1966 (and in July only 0.1 per cent above a year earlier), compared with increases of 2.8 per cent a year from mid-1964 to mid-1966.

In May and June, however, agricultural prices moved up sharply from the April low, and they increased moderately further in early July. The resumption of rising prices from April to early July reflected in large part a decline in animal slaughter and meat production and unusually poor spring and early summer crops of fresh fruits and vegetables due to bad weather. In recent weeks, however, the upturn in average meat prices has tapered off. With ample summer and fall crops coming in or in prospect, prices of fresh produce have declined; and, with the forecast of record crops, prices of wheat, corn, and soybeans have also declined.

On the other hand, farmer dissatisfaction with the sharply declining prices from the fall of 1966 to this spring has resulted in considerable pressure for government action to help raise prices. Actions have been taken to raise milk support prices, to curtail imports of dairy products, and to reduce substantially next year's wheat acreage. Altogether -- given the sustained strong consumer demands, particularly for meats, and also at times sizable military requirements, and the present supply outlook for meats and dairy products particularly, it appears likely that prices of foods and foodstuffs will hold up over this half-year but may not increase further.

Consumer prices: From June, 1966, to June, 1967, the CPI rose as much as (2.7 per cent) as it had from mid-1965 to mid-1966, although the decline in food prices from last fall to April acted to slow the rise in the CPI over that period. This development reflected the fact that prices of non-food commodities (at retail) rose much more from mid-1966 to mid-1967 than they had earlier. Service prices also rose faster. And the slowdown in the pace of increase of food prices was thus offset in the total.

To a large extent the stepped-up rise in consumer prices for non-food commodities has reflected rather sharp increases for apparel and gasoline and, since the beginning of this year, a marked climb in used car prices. For both apparel and gasoline, the price increases at retail were much larger than at wholesale. Because in general consumer demands for non-food commodities were not particularly strong in late 1966 and early 1967 (and in view of the broad demand situation as well as the slowing of the industrial price rise at the wholesale level), the rather pronounced increase in retail prices was surprising. However, retail stores have apparently been subject to especially large upward labor cost pressures, and retail margins have widened, particularly for apparel. In June, the earlier rise in retail prices of non-food commodities slowed appreciably, when summer sales -- and lower prices -- for apparel were instituted earlier than usual and used car prices showed little further increase.

While service prices rose more from June, 1966, to June, 1967, than in the preceding year, the rate of increase so far in 1967 (about 3.5 per cent) has been slower than during most of 1966. Sharply rising mortgage interest rates contributed to the higher rate of increase during 1966; thus far in 1967 they have edged off. Medical service prices continue to be among those increasing most rapidly, but the annual rate of increase has been 7 per cent so far this year compared with 9 per cent over the last year.

In looking to the near future, the rise in retail food prices apparently continued in July although at a sharply diminished rate. For the rest of this year, while retail food prices may continue to rise, the increase may not be as rapid as from April to early summer and would thus not act as a major influence boosting the CPI. The major question is what retail prices of non-food commodities are likely to do. The rise over the last year -- and particularly in the first half of 1967 -- was large in relation to changes in other prices, and it may be that the June slowdown is a sign of some moderation of upward price movements in this sector. However, with consumer demands now stronger, these prices may continue to move up at a sizable pace. Higher average new car price tags are in prospect for 1968 models. But (as over the last several years) the higher prices which reflect the addition of new safety equipment this year may be treated in large part as quality improvements and therefore may not result in an appreciable increase in new car prices as measured in the CPI. Service prices will, of course, continue to rise -- perhaps at around the 3.5 per cent rate prevailing so far this year and below the very high rates reached in 1966.

This review of price developments has convinced me that, while some further price increases are in prospect, we clearly are not caught up in a situation of general inflation. Far from it. On the other hand, the emerging demand conditions are obviously generating strong potentials for inflation, and now is the time to insure that such potentials are not realized. The President's proposed revenue and expenditure program provide the best means to achieve this goal.

The Mosaic of Wage Trends and Unit Labor Costs

From the view point of national stabilization policies, the outlook for wage developments is no more optimistic than it is for prices. One calculation shows that recently negotiated wage and fringe benefit packages have involved an increase of about 5½ to 6 per cent in total labor cost. Moreover, this range of increases seems most likely to persist in the near future.

The consequences of negotiated wage settlements in manufacturing have been particularly striking. Straight-time hourly earnings in the first half of 1967 were 4½ per cent above a year earlier. This was the largest increase in the first half of any year in the last decade. The rise in the cost of fringe benefits has also been substantial. Supplements per man-hour (including legally required Social Security taxes and other employer contributions to public as well as private programs) recently have been rising at an annual rate of roughly 11 or 12 per cent. In contrast, during the period 1960-65, the rate of increase averaged about $6\frac{1}{2}$ per cent per year. Although the funding of some of these added costs sometimes can be postponed, this rapid increase must necessarily mean a significant boost to current labor costs.

The forces inducing workers and trade union negotiators to press for higher wage settlements are enormous. Over the last year, increases in consumer prices have eroded real weekly earnings in manufacturing. Sizable wage settlements in other industries have not gone unnoticed. This is particularly true of wage and fringe adjustments in the construction industry, where recent increases have ranged between 6 and 10 per cent.

Wage negotiations are also being complicated somewhat by the desire of skilled workers for extra wage increases to re-establish traditional wage differentials that are often compressed in a period of tight labor markets. Such skill differentials were provided in the recently negotiated rubber and electrical workers contracts, and they are being demanded in the railroad and auto negotiations. In fact, this particular issue is reported to be one of the most difficult features of the current negotiations in the automobile industry. Skilled workers in the auto plants have veto power over a contract, and at the moment they seem unhappy about the tenor of the negotiations.

In the meantime, previous increases in labor costs and the recent low productivity rates (averaging less than 1 per cent above a year ago in the last few quarters) have combined to produce sharply higher costs per unit of output in manufacturing. During the second quarter of this year, the index stood at 106 per cent of its 1957-59 base. This was the highest point for this index in the last two decades. At this level, unit labor costs were running about 5½ per cent higher than a year ago, although the rate of increase during the last few months remains somewhat more moderate than earlier.

Some easing of the pressure on costs may be anticipated later this year as productivity continues to recover. A slowdown in productivity growth is not unusual in a period of production declines, with its associated under-utilization of capacity, so a rebound should occur with the expansion in output anticipated in the months ahead. However, there seems to be little likelihood of an easing of pressure on the wage front.

Thus, one must also expect continued pressure on profit margins, which have already shrunk substantially. For example, the ratio of profits to sales in manufacturing has declined from 9.8 per cent in early 1966 to 8.5 per cent in the first quarter of 1967 and probably declined further in the second quarter of this year. On the other hand, despite this narrowing, profit margins in manufacturing remain close to the average recorded over the last decade -- and well above the low points reached in earlier periods of lessened economic activity. Thus, while the pressure on profits is unmistakable, it does not appear to justify a general rush to restore margins through successive rounds of price increases.

Price Stability and the Balance of Payments

Domestic price stability is obviously of critical importance to our balance of payments and the international position of the dollar. During the first half of this decade, we were able to effect considerable improvement in the competitive position of our exports simply by avoiding domestic inflation -- while prices rose steadily abroad. Between 1960 and 1964, U.S. prices rose much less than those in other industrial countries.

In the last two years or so, however, this cost advantage which we enjoyed has eroded substantially. Between the end of 1964 and the second quarter of this year, average prices of U.S. industrial goods rose by about

5 per cent, while they had remained unchanged over the previous five years. In roughly the same 2½ years since 1964, industrial prices rose by only 2 per cent in Italy; by 2 per cent in France, and by 2½ per cent in Germany. Only in Japan and the United Kingdom did the rise in industrial prices equal or exceed that which occurred in the United States.

This faster advance in our relative price level certainly has not aided our exports. During the second quarter of this year, merchandise exports were at a seasonally adjusted annual rate of $30.9 billion, about the same as in the first three months of the year. Imports in the second quarter declined to an annual rate of $26.3 billion. Thus, the trade surplus for the second quarter was at an annual rate of about $4½ billion, compared with $4 billion in the first quarter. But it was still far below the $6½ billion rate achieved in 1964 and too low to meet our needs.

The failure of our exports to forge ahead at a greater rate this year toward regaining the much larger margins over imports enjoyed in 1964 and 1965 can be attributed partly to the persistence of recessions in some of our major foreign markets. This is especially true of Germany, where employment has declined about 3 per cent and industrial output by about 10 per cent since early last year. Reflecting the adverse effects of the German experience, other markets in continental Europe (particularly France) have also shown considerable weakness. This weakness, in turn, has lessened the demand for exports from the U.S. and the U.K.

A rough calculation by a member of the Board's staff suggests that the combined imports of continental European countries this year may be running about $5 to $6 billion below the level consistent with relatively full employment -- with perhaps $2½ billion of the short-fall concentrated in Germany. On the other hand, exports of continental Europe may be only $3 to $4 billion below what might be expected under conditions of relatively full employment. Thus, the trade surplus of the Continent this year may be as much as $2 billion above the trend. In contrast, for the U.S. imports may not be appreciably below the level consistent with high employment, while U.S. exports are being dampened by the recessions in Europe. The net result may be that U.S. exports and our trade surplus are running $1 billion or more below trend this year.

But even after allowance for this cyclical short-fall, our trade surplus is too small, given our heavy commitments around the world, and our persistent payments deficit. In this situation, we certainly cannot look forward with equanimity to a resurgence in aggregate demand next year so rapid as to accelerate imports, hold down our ability to meet export schedules, erode further our competitive position, and thus cause further shrinkage in our trade surplus.

Price Effects of the Surtax

Since one objective of the 10 per cent surtax proposal is to reduce inflationary pressures in the economy in 1968, one must naturally ask:

just how much impact is the increase in income taxes expected to have? Unfortunately, no ready answer is available. I am sure that the statisticians and econometricians would wish to trace the effects of the tax increase through their mathematical models of the economy before offering a reply. Such an effort would undoubtedly require several months of hard work. In the meantime, one can sketch the broad range within which the price effects of the surtax may fall. For this purpose, one might start with the numerical projections which the Chairman of the Council of Economic Advisers presented in testimony before the House Ways and Means Committee on August 14.

In that statement, Mr. Ackley estimated that, if Congress were not to accept the President's tax proposal, GNP might rise by perhaps $29 billion to $35 billion during the last half of this year -- and by as much as $60 billion from mid-1967 to mid-1968. Even at the low end of this range, GNP would be in the neighborhood of $783 billion in 1967 and $815 billion in the second quarter of 1968. Mr. Ackley also estimated that a rise in GNP of around $50 billion over the next year would be roughly in line with the expansion of our productive capacity -- permitting real output to grow at an annual rate of about 4 per cent, plus an allowance for price increases already built into the economy. However, because we currently have a small amount of excess capacity, he suggested that we could welcome a growth rate slightly above 4 per cent. With the 10 per cent surtax in effect, CEA's projections show GNP growing by about $55 billion through the second quarter of 1968.

On the basis of these projections, it appears that enactment of the surtax would dampen (although not eliminate) inflationary pressures in the year ahead. A growth of $60 billion in GNP by mid-1968 (which Mr. Ackley estimated might occur without the surtax), would represent a gain of 7.7 per cent. Although one cannot with any precision distribute this gain between real output and prices, a substantial share (perhaps as much as 3 per cent) would reflect price advances -- as measured by the GNP implicit deflator. With the surtax enacted as proposed, the projected growth of $55 billion in GNP next year would represent a rise of 7 per cent in GNP. Again no hard division can be made between the growth or real output and an increase in prices. Yet, the advance in real output would be almost as large -- if not equally as large -- as with the $60 billion advance in GNP. Thus, the surtax initially would restrain the growth of GNP through mid-1968 by perhaps $5 billion. However, the $5 billion of restraint would represent mainly restraint on higher prices. So it is clear that the surtax would have a noticeable (if not precisely measurable) effect on the general price level.

However, it is also worth noting that a rise of only $50 billion in GNP -- a rise about in line with the 4 per cent growth rate of our productive capacity -- would still mean a price increase of almost 2½ per cent between mid-1967 and mid-1968, reflecting the cumulation of the built-in price advances mentioned above. While a more refined examination would yield a better quantitative estimate of the effect of the surtax on prices, the analysis presented here makes it unmistakably clear that the surtax is needed to moderate inflationary forces in the coming year.

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