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Statement by

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Committee on Banking, Housing, and Urban Affairs

Hearings to Consider Legislation to Extend

the Council on Wage and Price Stability

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Mr. Chairman, members of this Committee, I am pleased to present the views of the Federal Reserve Board on extending the Council on Wage and Price Stability for two years. The Council can play an important role in the fight against inflation, and the Board supports extending the authority of the Council to 1981.

In the past year inflation has worsened considerably, and remains the Nation's major economic problem. Over the four quarters of 1978 most general price measures rose about 9 per cent--substantially faster than the 6-1/2 per cent rate in 1977. To some extent the acceleration of inflation last year reflected a sharp run-up in farm prices, which are particularly vulnerable to temporary disturbances. A more troubling longer-run development in 1978, however, was the upward trend in prices that are more closely associated with movements in production costs. When food and energy prices are excluded from the Gross Business Product deflator, this measure of inflation moved up from 6-1/2 per cent during 1977 to 8-1/4 per cent last year.

The acceleration of inflation occurred while product and labor markets were tightening. By year-end, the economy was operating at rates of capital and labor utilization that, although not quite as high as during the 1974 price surge, were nevertheless substantial. An intensification of cost pressures, accompanied by incipient excess demand, was the principal source of inflation in the past year.

The sharp rise in production costs was the result of a combination of rapidly rising labor compensation and dismal productivity performance. Hourly compensation rose at a 9-3/4 per cent annual rate during 1978 -- more than 2 percentage points faster than in 1977. A good deal of the acceleration from 1977 to 1978 -- perhaps about half -- can be attributed directly to Federally mandated increases in minimum wages and in social insurance taxes. Weak productivity growth exacerbated cost pressures, and, as a result, unit labor costs accelerated sharply to a 9 per cent rate during 1978 from just over 6 per cent a year earlier.

Such rapid acceleration in costs, being transmitted to prices, often leads to further acceleration of costs including wage demands. Throughout the 1970's, this chronic cycle of wage and price increases has been curtailed only briefly by downturns in activity, only to worsen again when the economy heated up. One important contributing factor in the spiral has been the sluggish performance of productivity in recent years.

Over time, mechanisms have been developed in the labor market -- either formally or informally -- to ensure that wages kept pace with increases in the cost-of-living. As long as growth in labor productivity matched demands for higher wages, real income continued to grow without generating significant upward pressure on prices. In the 1970's, however, productivity increases faltered, and it now appears that, at least in the near-term, the trend rate of productivity growth is likely to be only about one-half the nearly 3 per cent trend over the two preceding decades.

The recent, low rate of productivity growth adds a more serious dimension to our inflation problem. Demands for the type of real income gains achieved a decade ago are inconsistent with current productivity trends. Pressures to achieve unrealistically large increases in real incomes in the face of slow productivity growth threaten to result in an escalation of inflation. Moreover, even if real wage demands are brought into line with productivity, inflation will not automatically diminish. Forceful efforts additionally must be made to break into the vicious circle in which prices determine wages and wages determine prices.

The main burden of the anti-inflation battle has fallen, and probably must continue to fall, on the monetary and fiscal authorities. The appropriate goal of monetary and fiscal policy in the coming year is to moderate the pace of current economic growth in order to alleviate the inflationary pressures brought on by strains on the nation's productive capacity. Recognizing this, the Federal Reserve has moved in the direction of monetary restraint, and the President has recommended a tighter rein on government spending. It is highly desirable not to place the entire burden of the fight against inflation on demand management. As our policies of restraint ease pressures from the demand side, an incomes policy such as the one proposed by the President last October can make an important contribution to unwinding the wage-price cycle.

The program of voluntary wage and price guidelines set by the President is a direct attempt not only to halt the upward spiral of costs and prices but also to reduce the rates of wage and price increase significantly from current rates. In this regard, the guidelines are based on sound economic logic. They allow labor compensation to rise 7-1/2 per cent--7 per cent for private payments plus 1/2 per cent for Federal payroll taxes. Assuming trend productivity growth of about 1-1/2 per cent, unit labor costs--a major factor in price determination from year-to-year--could drop under the guidelines to about 6 per cent. If prices slowed down, following the guidelines, and cost pressures diminished, real income gains would continue to be realized, but at a significantly lower rate of inflation.

Favoring the prospects of the wage-price restraint program is the fact that it has been undertaken in the face of an expected slowing of economic activity. Previous attempts to institute incomes policies, such as the Kennedy-Johnson guideposts, were rendered ineffective by a worsening of demand pressures. Business and labor leaders can be expected voluntarily to adopt moderation in wage and price setting only if they are persuaded that the Federal Reserve, the President, and the Congress have committed monetary and fiscal policies to containing inflation.

The Council on Wage and Price Stability has been given the task, by the President, to implement the voluntary guidelines program. This implementation has two parts: (1) translating the President's broad request for wage and price moderation into a set of specific standards and regulations and (2) monitoring actual wage and price setting in order to determine how firms and employee groups meet the standards. It is desirable that a single organization perform both tasks. This allows the knowledge gained in establishing standards for a vast array of industrial pricing and labor-management arrangements to be applied to fair and timely determinations of compliance.

In addition, the Council has the responsibility to notify the public of its findings; this is an important function since the weight of public opinion can be a critical tool in building support for compliance with the program. These extensive tasks now are being performed by a staff of just over 100, and the President has proposed that the number be expanded to about 230. This increase, it seems fair to say, does not pose the threat of an unwieldly bureaucracy.

Aside from the day-to-day task of administering the guidelines program, the Council has an opportunity to gain insights into the complex machinery of wage and price determination. As the Council's work proceeds, it will be able to identify sectors of the private economy that require special attention. One example to date has been the Council's several reports on hospital charges and physicians' fees. Medical care costs have been a significant factor in exacerbating inflation for more than a decade.

The Council is charged as well with examining inflationary pressures that emanate from government activities. In recent years, we have become increasingly aware that many government regulations that contribute to desirable social goals also may involve hidden costs, particularly in the form of higher prices. The Council has the important function of injecting cost-consciousness into environmental, safety, and other standards that frequently extensively ignore costs and of encouraging competition where regulation has weakened it.

Finally, I would like to comment briefly on the Real Wage Insurance program that the President has proposed in conjunction with the guidelines program. Its purpose is to strengthen the guidelines program by encouraging acceptance of the 7 per cent wage standard. It would do this by reducing the prospect of real income erosion if actual inflation were to exceed 7 per cent. Participating wage earners would receive a tax rebate of up to $600.

This form of tax-oriented incomes policy should be more cost-effective when rising labor costs are the principal source of inflation.

In such a situation, broad compliance with wage and price guidelines would hold down the rate of inflation. That would keep the cost of real wage insurance moderate. Unpredictable increases in prices, such as food or energy, could raise inflation rates even in the presence of wage restraint. In such a case, the cost of the program might mount excessively. Limits, therefore, have been proposed on the extent of compensation provided by the program in order to control the risk to the Federal government of adding substantially to the deficit. Although a real wage tax incentive program may be difficult to design, it deserves serious consideration as one part of a broadly based anti-inflation effort.

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