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ECONOMIC POLICY AND THE  
RESTORATION OF DOMESTIC EQUILIBRIUM

A Paper Presented

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In mid-summer, 1968, the assessment of the near-term outlook for the American economy could be a rather trivial task. With two-thirds of the year already behind us -- and with the central question of fiscal restraint having been resolved -- the main contours of the economy's performance during 1968 are fairly well set. Yet, each new crop of statistical indicators adds to the debate over whether the American economy is currently moving on a path that will lead to reduced inflationary pressures in the near future.

I am flattered that I have been asked to assess this prospect. However, for me personally, this assignment poses a serious difficulty. With fiscal restraint finally having joined in the fight against inflation in the United States, a natural question is: Will there be a significant and early relaxation of monetary restraint? This question has been cast into even sharper focus by the recent reduction in the discount rate from 5-1/2 per cent to 5-1/4 per cent at some Federal Reserve Banks.

Having recognized the critical importance of this question, let me acknowledge promptly that I cannot provide the answer. Quite obviously, only the Federal Reserve Board and the Federal Open Market Committee as a whole can determine the future course of monetary policy. Thus, I cannot -- and would not wish to -- speak for any of my colleagues or to speculate on what decisions will be made by these bodies in the period ahead.

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However, I do have a personal view on the proper role of monetary and fiscal policy in the effort to achieve domestic equilibrium. Although I have expressed this view a number of times in recent months, it may be helpful to do so again -- stressing once more that I am speaking only for myself: In my judgment, the magnitude of the fiscal measures adopted by Congress last June -- involving higher income taxes and a reduction in expenditures as proposed in January by the Federal Government -- would allow some relaxation of monetary restraint. At the same time, I also believe that such relaxation should not be undertaken too early and should not be pursued to the point of erasing the beneficial effects of the fiscal restraint which has been won at such a great cost. On the other side of the issue, however, I also believe that monetary policy must remain constantly alert and ever-ready to respond to changing conditions to assure that the desirable moderation of economic activity does not degenerate into a recession under the cumulative impact of both fiscal and monetary restraint -- especially since the latter had been underway for a number of months before the fiscal measures were finally adopted.

Putting aside the subject of the future path of monetary policy, we can turn to an assessment of the strategy of domestic stabilization policy embodied in the fiscal measures enacted in late June. The issues to be examined can be summarized succinctly in the following questions:

- Will excess demand slacken during 1968?
- Will the rate of economic growth slow down as expected?
- Will the hoped-for moderation in inflationary pressures materialize?
- Will domestic equilibrium be restored without creating excessive unemployment?

Without attempting to forecast the detailed behavior of the economy over the months ahead, one can form a fairly firm judgment about the near-term outlook on the basis of the evidence already in hand. With such an assessment as background, I will conclude with a few observations relating to my own views on monetary management.

Finally, while I shall concentrate on the domestic aspects of stabilization policies, these obviously have implications for our balance of payments. However, discussion of that topic is reserved for another occasion.

#### The Strategy of Stabilization Policy

Undoubtedly, in the absence of an early end to the Vietnam war, the principal factor influencing the economy during the rest of 1968 and into the first half of 1969 will be the strong fiscal measures which became effective in July. But in evaluating the probable impact of these fiscal moves, one should remember that a restrictive monetary policy had already been pursued for a number of months.

#### The Record of Monetary Restraint

In carrying out this policy of monetary restraint, the Federal Reserve took a number of actions -- which have been widely discussed. However, it may be helpful to summarize them again:

- The discount rate was raised three times: from 4 to 4-1/2 per cent in mid-November; to 5 per cent in mid-March, and to 5-1/2 per cent effective April 19. The first increase was made in the context of adjustment following the devaluation of sterling, and the second move was part of a package of coordinated measures designed to cope with speculation against the official price of gold. The last increase represented a further step to bring about greater restraint to help counter domestic inflation and to contribute to improvement in our balance of payments.
- About \$535 million of bank reserves were absorbed in mid-January by an increase of 1/2 percentage point in reserve requirements on demand deposits above \$5 million at each member bank.

- Open market operations, from last November through June of this year, were used to absorb (rather than supply) reserves, so that the net growth in reserves during this period came about entirely through member banks borrowing from Federal Reserve Banks. Even so, during much of this period (and even into August) a considerable volume of Treasury financing has been accommodated.
  
- The maximum rates of interest payable on large-denomination time deposits were raised slightly effective April 19. This move was intended to moderate the rate of attrition in such deposits -- and not to ease credit conditions generally. Ceiling rates on savings and other time deposits were not changed.

The impact of these actions on the money market and credit conditions was substantial. The severest features of restraint were recorded in May, when bank reserves were shrinking and some interest rates moved to the highest levels recorded in many years.

In the six months ending in May, total reserves expanded at an annual rate of 3.5 per cent, compared with just under 10 per cent in 1967. Moreover, in the March-May period, total reserves actually declined at an annual rate of 2.4 per cent -- in contrast to an expansion at a 6.4 per cent annual rate during the four months ending in March. Nonborrowed reserves declined at an annual rate of 1.3 per cent during the December-May period, but in April and May taken together the net decline was at an annual rate of 3.6 per cent. In the six months ending in May, total member bank deposits (a fairly good indicator of the availability of commercial bank credit) rose at an annual rate of 3.2 per cent. This rate was slightly more than one-quarter that registered for the full year 1967. Even so, during the April-May period, such deposits actually shrank at an annual rate of 1.5 per cent.

The money supply expanded at an annual rate of 4.0 per cent during the December-March period, compared with 6.5 per cent in 1967 as a whole. Beginning in April, however, the money supply began to grow much more rapidly, registering a 8.8 per cent annual rate of expansion in the April-May months. To some extent, this spurt reflected the sharp decline in U.S. Government demand deposits in commercial banks. However, the quickened pace of economic activity in the first half of the year and the sharp rise in stock market trading (which brought noticeable processing delays) also probably contributed to the sizable rise in the money supply.

The impact of restraint was clearly visible in the money and capital markets. In May, yields on 3-month Treasury bills averaged 5.66 per cent, compared with 4.72 per cent last November. In fact, the climb in yields was especially large in May (which saw a rise of 28 basis points) as the outlook for passage of the fiscal restraint measures was thought to be less promising. The Federal funds rate, which averaged 4.14 per cent in November, rose to an average of 6.10 per cent in May. Here also the one-month gain (36 basis points) was quite large.

Time and savings deposits at commercial banks expanded at an annual rate of 6.2 per cent during the six months ending in May. This was a little more than one-third the rate recorded in 1967. In April and May combined, the annual rate of expansion was 2.9 per cent.

As the enactment of the fiscal restraint measures became assured in June, market expectations shifted noticeably. Reflecting the anticipation of less pressure in the market, 3-month Treasury bill yields receded to an average of 5.52 per cent, but day-to-day conditions in the money

market remained tight (e.g., the Federal funds rate averaged 6.09 per cent for June as a whole). Borrowing by member banks from Federal Reserve Banks averaged somewhat less in June compared with the level recorded in May, but their net indebtedness to the System (which averaged \$326 million in May) did not change very much in June.

Thus, the passage of the tax and expenditure measures in June came against a background of substantial restraint brought about by the monetary authorities. Again, these monetary conditions should be kept in mind in assessing the expected impact of the fiscal actions.

#### Dimensions of Fiscal Restraint

The fiscal measures adopted in June, including the surtax on personal and corporate incomes and a cutback in planned Federal Government expenditures, implies fiscal restraint in the neighborhood of \$16 billion for fiscal 1969. While the fiscal year began with an increase in personal withholding taxes of \$6 billion, for fiscal 1969 as a whole, the surcharge is expected to add \$7.8 billion to personal income taxes. Corporations will pay an additional \$3.8 billion as a result of the surtax and speedups. The difference between the \$6 billion immediate rise in withholding and the \$7.8 billion personal income surcharge for the fiscal year will be made up in the first half of next year, when the increase in individual income taxes will run at an annual rate of \$10 billion. In the last half of this calendar year, there will also be an increase in actual deductions from paychecks for social security, since the salary base to which social security taxes apply was raised from \$6,600 to \$7,800. The increased deduction will amount to \$2 billion at an annual rate in the third quarter and \$3 billion in the fourth

quarter; employers will be paying similarly large employment taxes.<sup>1/</sup> In January, 1969, there will be an increase in the rate of social security taxes to cover benefits (approved by Congress in 1967) which became effective this year. These higher taxes should yield around \$3 billion, \$1-1/2 billion each for employers and employees, the impact of which will be immediate.

On the expenditure side, the Federal government is apparently moving rapidly to implement the \$6 billion reduction in outlays required by law. (These cuts are from Budget levels proposed in January -- not from present levels.) The composition of the reductions is unknown, but a sizable amount may come out of planned loans and other items not directly included in the National Income Accounts budget (NIA). A substantial share (perhaps as much as half) of the required reduction is now expected to come from non-Vietnam defense outlays. Most of the remainder may come from Federal grants to the States, as most transfer payments cannot be cut. Interest payments, veterans' benefits and Vietnam spending are exempted from the budget ceiling, and may be about \$4 billion above the January estimate.

Aid to education and to the cities may also be cut substantially. (For example, the Department of Housing and Urban Development spent over \$600 million less in the fiscal year just ended than was anticipated in January, mostly because grants were less than projected.) Moreover, because of the budget cuts, some agencies may have to reduce staff in

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<sup>1/</sup> Although this tax increase is spread evenly over the calendar year in the National Income Accounts budget, the actual impact of the increase on disposable income comes in the latter part of the year. Since the percentage of annual salary now required to be paid in by each worker has been raised, many more workers who formerly were through with paying such taxes by midyear or a little later now will be required to pay all year.

excess of the numbers required directly by the reduction in personnel ceilings.

With prompt action to hold Federal spending within the bounds of the imposed restraints -- and this immediate action apparently is being taken -- Federal expenditures on an NIA basis may level off at a rate not too different from that in the current quarter. But even with this leveling in NIA expenditures over the remainder of fiscal 1969, the unified budget outlays will be up about 5 billion from fiscal 1968, after adjustment for the exempted increases in Vietnam and elsewhere and the \$6.0 billion cut.

If the planned fiscal restraint is carried out, the reduction in the Budget deficit from fiscal 1968 to 1969 would be in the neighborhood of \$23 billion. On an NIA basis, the change from the second quarter of 1968 to the same period in 1969 would be around \$15 billion. The deflationary impact of such a shift -- quite obviously -- would be considerable. But just how severe the net effects would be on the economy as a whole would depend heavily on the behavior of the key sources of growth in the private sector -- business investment in inventories and fixed equipment and outlays on residential construction.

#### Outlook for Economic Activity

As I look ahead through the rest of 1968, I see nothing to suggest that economic growth will be sustained at a level even close to that registered during the first half of the year. On the contrary, the available evidence suggests definite moderation in the rate of expansion of output. This outcome seems to be in prospect despite the apparent

strength shown recently in a few indicators -- such as the sizable rise in retail sales in July, the further moderate expansion in industrial production in the same month, and continued high sales of automobiles in the early days of August.

Without myself attempting to forecast gross national product (GNP) for 1968 as a whole, I do note that a rough consensus seems to have emerged among most observers which suggests a figure in the neighborhood of \$854 billion, measured in current dollars. This level would represent an increase of about \$64 billion from the \$789.7 billion recorded in 1967. Since the increase in GNP in the first half of this year was just over \$40 billion, the gain in the closing six months might be little more than one-half as large. This would represent a seasonally adjusted annual rate of growth (measured in current dollars) of less than 5 per cent in the second half, compared with just under 10 per cent recorded in the January-June period.

Just how firmly based is this expectation of a substantial slowdown in the rate of growth? An examination of the underpinnings of aggregate demand suggests that the foundations of such an outlook are quite well grounded.

First, let us look at the Federal Government sector. In the first half of this year, Federal expenditures rose by \$6.5 billion, accounting for over one-sixth of the expansion in GNP. Since efforts are already getting underway to reduce non-exempt expenditures to ensure that the fiscal 1969 ceiling is not breached, a noticeable slowdown should develop well before the end of this calendar year. Moreover, in the absence of any major expansion in troop commitments in Vietnam,

one cannot readily foresee an appreciable further rise in total defense expenditures during the rest of 1968. In the first half of this year, defense outlays rose by \$4.4 billion, absorbing two-thirds of the increase in total Federal Government expenditures. In the non-defense area, the recent pay increase for Federal employees (amounting to some \$1.6 billion at an annual rate) will be recorded in the third quarter statistics. Aside from this source, one can identify very little further rise in Federal expenditures for civilian purposes in the closing months of 1968. Thus, the Federal Government sector, far from contributing to an expansion of GNP, will probably be a principal, direct source of moderation in the demand for goods and services. After all, this was a major goal of the fiscal restraint proposals adopted in June.

In addition, the Federal expenditure pruning will undoubtedly cause the States and localities to feel the impact of the economy drive. Federal grants to States, which accelerated greatly in the last year, are expected to expand at a much slower rate. Thus, while State-local expenditures will continue their inexorable upward march, the rate of increase will also be restrained by the reduced availability of Federal contributions.

#### Behavior of Consumers and Residential Construction

The recent behavior of consumers is one of the principal reasons why some observers have been expressing doubts about the likelihood of a moderation in economic advance during the rest of this year. The sharp rise in retail sales in July, as noted above, is perhaps the main support for such doubts. In that month, sales at retail outlets were 3 per cent

above the June level and 10 per cent above July a year ago. The expansion was broadly based; sales at durable goods stores rose by 5 per cent in July and those at nondurable establishments by 2 per cent. Automotive outlets and general merchandise stores registered the largest gains, but sales of furniture and appliances also increased significantly.

Before proceeding with the discussion of the outlook for consumers and the household sector, let me stress that -- in my opinion -- the July retail sales figures should not be taken as evidence that the income tax surcharge will have no impact on consumer spending. Disposable personal income in July was affected very little by the tax increase, since the additional taxes were not deducted from paychecks until after mid-month. Rather than trying to infer from the July sales figures something significant about the probable pattern of consumer behavior over coming months, a better course would be to focus on the fundamental factors influencing that behavior -- i.e., prospective changes in personal income and consumers' attitudes toward saving.

In the first two quarters of this year, personal income registered an average gain of \$16-17 billion. During the third and fourth quarters (reflecting a slower rise in employment and perhaps some decline in the average workweek in manufacturing), the increases in personal income are likely to fall considerably short of the average gains recorded earlier in the year. Since the surtax will be absorbing over \$6 billion of these gains (at an annual rate), the increase in disposable income in the third quarter will be exceptionally small. In fact, the gain may be the smallest recorded in five years. As the rate of growth in output moderates further in the

fourth quarter, the rise in personal income in the closing months of the year may be even smaller than in the July-September period.

In the face of a reduced rate of expansion in personal income, it does not seem likely that consumer expenditures will accelerate appreciably in the second half of 1968. Furthermore, a more moderate pace of consumer spending may already have set in. During the second quarter, the rise in personal consumption outlays dropped sharply to about \$8 billion, or less than half the \$17 billion advance that occurred in the first three months of the year. Despite the sharp rise in retail sales in July, the third quarter increase may be of roughly the same magnitude as that reported for the second quarter, and the final three months may record approximately the same experience.

This conclusion is reached despite the fact that consumers will probably try -- in the short-run -- to maintain their level of expenditures, in the face of a downward shift in disposable income, by reducing the proportion of income saved. After all, such a response would be normal. Because of this prospect, saving as a share of disposable personal income may decline in the third quarter from the 7.7 per cent rate recorded in the April-June months. How far the rate of saving may fall is obviously a critical question. Since the final quarter of 1966, the rate has exceeded 7 per cent; this is a very high rate -- at least a full percentage point above what most observers had come to regard as normal. An important cause of this high saving rate, as reported in surveys of consumer attitudes, has been continuing uncertainty generated by the Vietnam war. Paradoxical as it may seem, a second reason reported in the surveys is the pace of domestic inflation itself.

But whatever the explanation of the persistently high saving rate, some analysts are troubled by the possibility that a sizable drop in the rate might offset the increase in withholding taxes -- thus enabling consumer expenditures to expand more rapidly than they did in the second quarter. After all, with disposable personal income in the neighborhood of \$590 billion, a decline of one percentage point in the saving rate (from 7.7 per cent to 6.7 per cent) would add almost \$6 billion to personal consumption expenditures -- roughly equal to the rise in withholding taxes.

Actually, in the above assessment of the impact of the surtax on consumer behavior, I have assumed that some decline in the saving rate would occur during the rest of the year. Most of the decline may be registered in the third quarter, but the final three months may also show a further modest erosion. In fact, if the saving rate were to remain close to 8 per cent in the months ahead, the impact of higher withholding taxes on consumer expenditures and aggregate demand would be much more severe than most analysts have foreseen thus far. Only if the rate were to drop precipitously in the next few months would a lessened willingness to save serve as a major source of strength for consumer expenditures. Thus, this analysis suggests that the household sector is not likely to provide fuel for much expansion of economic activity during the rest of 1968.

Turning to residential construction, one cannot be optimistic regarding the strength this sector will impart to aggregate demand before the end of the year. It is true that housing starts in July -- contrary

to expectations -- were at a seasonally adjusted annual rate of 1,539,000 units, roughly one-seventh above the 1,349,000 new dwellings started in June. Thus, new residential units begun in July were back to the levels recorded during the late winter and early spring months. Also during July, however, new building permits issued in those areas which require them declined to a seasonally adjusted annual rate of 1,236,000, compared with 1,281,000 in June.

Because of the volatile nature of the housing statistics series, one must be particularly cautious in interpreting month-to-month changes in the housing figures. In view of the substantial moderation in the inflow of funds at thrift institutions through the spring, it seems most unlikely that outlays for residential construction will expand much -- if any -- from the seasonally adjusted annual rate of \$29.5 billion recorded for the second quarter. The more likely prospect is for a modest decrease in such outlays in both the third and fourth quarters. In the January-June months, expenditures on residential structures climbed by only \$1 billion, and the underlying conditions in the rest of 1968 will clearly be less favorable than they were in the first half of the year. On the other hand, if the availability of mortgage funds continues to improve (and July savings flows may have provided a faint indication of such a prospect), a revival in homebuilding could be underway by the end of the year.

#### Behavior of the Business Sector

Investment in plant and equipment in the business sector may rise moderately in the second half of the year. This was certainly the

indication given by the Commerce-SEC survey taken in April-May. However, the passage of the surtax, the reductions in Federal expenditures, and the slower rise in personal income were still uncertainties at the time of the survey. As businessmen re-evaluate their sales prospects and the outlook for profits in the light of the changed circumstances, there may be some downward revision of investment expenditures for future quarters. Certainly, the environment that is currently emerging is not conducive to an upward revision of investment plans. Even before passage of the surtax, business fixed investment rose by only \$2-1/2 billion, at a seasonally adjusted annual rate, in the first half of this year. The second six months may record an even smaller advance.

Businessmen are likely to invest in inventories at a rate substantially below that recorded in the first half. This will probably be one of the key factors bringing about a much slower economic advance in the second half of 1968. In the second quarter, net accumulation of nonfarm inventories climbed to nearly \$10 billion, compared with \$1.6 billion in the first three months. The third quarter rise may be only half the second quarter rate, and the final quarter may see a further slackening.

Steel inventories will undoubtedly play a strategic role. These stocks have been built up to levels at which the excess supply amounts to well over a month of normal production. The run-off in steel stocks following the settlement of the steel strike will be a dampening influence on industrial production and income for a number of months. Automobile stocks are also likely to be reduced more than seasonally following a

build-up to record levels last quarter. While inventory readjustments have only a temporary effect when demand is expanding, they can have important secondary effects on income and spending when other sources of expansion are not particularly strong.

From the foregoing analysis, it appears that the weight of evidence supports the expectation of a slowdown in the rate of economic expansion during the last half of 1968. None of the evidence points toward an acceleration.

#### The Outlook for Prices and Costs

Since a moderation in the growth of aggregate demand during the second half of 1968 is in prospect, what is the outlook for prices and costs? In other words, will the pace of inflation be abated? In my personal judgment, we can look forward to some lessening in the rate of increase in prices, but just how much lessening we can expect before the end of the year is uncertain.

This judgment is based on an appreciation of the simple fact that inflationary pressures have gotten ahead of us. While we debated the need for restraint on a rapidly expanding aggregate demand -- and the best way to bring it about -- inflation was allowed to propagate itself and to become imbedded in the cost of output in ever widening sectors of the economy. Consequently, we should have no illusions about the tenacity of the problem facing us. Because meaningful fiscal restraint came so late -- and because of the time lags involved before it becomes fully effective -- there appears to be little chance that inflation will have been eliminated by the end of 1968. On the other hand, some abatement in price advances does appear to be on the horizon, and the environment expected to be emerging as

the year closes will be conducive to substantial moderation of inflation as 1969 unfolds.

The scope of the task that confronts us as we attempt to restore domestic equilibrium can be seen clearly in the pattern and magnitude of price changes since the acceleration of military activity in Vietnam in mid-1965 gave rise to the current era of inflation. The Vietnam build-up, on top of an economy already operating close to full employment, put strong demand pressure on heavy industry. In the next 15 months, prices advanced sharply in defense industries and in the capital goods sectors, as the increment in expenditures for the war pressed unevenly on capacity and the supply of skilled labor.

By the fourth quarter of 1966, the implicit GNP price deflator (perhaps the most broadly-based measure of price changes) was advancing at a seasonally adjusted annual rate of 3.5 per cent. The rate of increase had been only 1.1 per cent in the third quarter of 1965 and 1.8 per cent in the fourth quarter of the same year. Also by the fourth quarter of 1966, the index of unit labor costs had risen to 102.4, a gain of 3.2 per cent since the third quarter of 1965. However, under the impact of a policy of vigorous monetary restraint, a modest move to a less expansionary fiscal policy, and a significant increase in the savings rate, some moderation was achieved in the first half of 1967. As output declined while businessmen struggled to reduce the excessive accumulation of inventories, the environment was not conducive to generalized price advances. In fact, in the second quarter of last year, the GNP deflator rose by 2.1 per cent, at a seasonally adjusted annual rate, compared with

3.5 per cent in the closing months of 1966. In the nine months ending in June, 1967, the consumer price index (CPI) rose 1.7 per cent, in contrast to 2.5 per cent in the same period a year earlier.

With the work-off of inventories accomplished by the second half of 1967, and with markets becoming strong, it seemed opportune to many businessmen to redress the substantial erosion of their profit margins occasioned by rising costs over the preceding months. By July, 1967, a renewed upswing in industrial prices was under way, and by June, 1968, the consumer price index was 4.2 per cent above a year earlier -- the largest 12-month gain in 16 years. Unusually sharp increases for consumer goods and services were accompanied, over the year, by large price increases for construction and for government services. In the second quarter of this year, the implicit GNP deflator rose at a seasonally adjusted annual rate of 4 per cent. Meanwhile, in mid-July of this year, the wholesale price index was about 2-1/2 per cent above a year earlier, with foods and foodstuffs up 2 per cent and industrial commodities up 2.7 per cent.

In fact, the rise in wholesale prices of industrial commodities over the last year has been as large as that from mid-1965 to mid-1966 and, for a period last winter, exceeded the fastest pace reached in 1965-66. The large wage settlement in the auto industry in the second half of 1967 had given a significant upward twist to wages and labor costs, and the accompanying sizable increase in new car prices -- reversing an 8-year declining trend -- helped speed the rise in the general price level. The upward thrust of wage rates was maintained through the spring and early summer of this year, supported in part by large wage settlements -- with

continuing emphasis on much higher increases in the first year of the contracts (so-called "front loading") -- in the copper, aluminum and steel industries. These three major wage settlements in turn were accompanied by a sizable increase in prices, as unit labor costs continued the sharp upward trend that began in late 1965.

Since March, the earlier sharp rise in wholesale prices of industrial commodities has tapered off somewhat. Special material supply developments have contributed significantly to this deceleration, but throughout industry price increases for industrial commodities have become more selective.

Prices of foods and foodstuffs in 1967 were down from their 1966 peak. However, since the turn of this year, food prices have risen substantially again as production of livestock slowed and consumer demands continued to rise. Moreover, additional Federal action was taken to raise prices of dairy products, and unseasonable weather limited supplies of fruits and vegetables.

The consumer price index, unlike the wholesale price index, has continued to rise at a rapid pace, partly because the index covers services and foods which are less sensitive to developments in industrial demand. Actually, for some time, prices of consumer products have been increasing more rapidly at retail than at wholesale. Since early 1967, prices of consumer goods have increased at an annual rate of 3-1/2 per cent at retail compared with 2.2 per cent at wholesale. This partly reflects the fact that wage rate increases in the distributive industries (especially at the retail level) have outpaced those in manufacturing, partly because of very substantial minimum wage increases in February 1967 and 1968.

Consumer spending for goods has behaved erratically, but a very sharp spurt in the early months of this year and another bulge in retail sales in July made it possible for sellers to pass on their rising costs. Automobile sales have been particularly strong. Prices of services included in the CPI have increased 5 per cent over the last year, the largest 12-month gain on record. Service industries have also been subject to powerful upward labor cost pressures, accentuated by higher minimum wage costs, and demand for services has remained strong.

Looking ahead, however, there are some encouraging factors in the wage situation. The only important collective bargaining contract remaining this year in the pace-setting durable goods sector is the aerospace industry, and the pressure from wage adjustments should be alleviated somewhat next year when a smaller number of large wage contracts are due for settlements. In 1969, the number of durable goods workers affected by contract negotiations will drop by more than half and will comprise less than 25 per cent of all workers affected by terminations. Also, most of the settlements arrived at in the last two years have called for a larger wage increase in the first year than in the second and third year. Thus, many workers in organized industries will automatically get smaller boosts in income in 1969 than in 1968, thus taking some pressure off costs. Moreover, there was much less of a tendency for cost-of-living adjustment provisions to be written into the new agreements, and in some instances cost-of-living provisions were actually curtailed. Also, no significant increase in the minimum wage is scheduled for next year. All of these considerations point toward lessened pressure on the costs of output -- and consequently on prices.

Outlook for Employment

With national economic advance slowing down in the months ahead, the growth of employment is expected to be quite modest. From the fourth quarter of 1967 to the same period this year, nonfarm employment may rise by roughly 1.5 million. Since the number of workers on nonfarm payrolls rose by slightly more than 1 million in the first two quarters, the gain in the last six months of 1968 may be less than half that figure. Moreover, employment in manufacturing may actually show a modest decline during the course of 1968. In the first half of the year, factory jobs rose by 200,000. However, with the expected easing off in industrial production (and with the capacity utilization rate in manufacturing declining somewhat below the 84.5 per cent recorded in the second quarter), even this minor gain in factory employment may be eroded by the end of the year -- thus leaving the level of manufacturing employment about where it was at the close of 1967.

The civilian labor force may expand by just over 1 million from the fourth quarter of 1967 to the fourth quarter of this year. Since employment may expand about as much in the same period, the unemployment rate in the final three months of this year may be close to the average of 3.9 per cent registered in the closing months of 1967. Yet, compared with the second quarter of this year (when the unemployment rate averaged 3.6 per cent), this would represent a modest increase in joblessness.

However, as far as unemployment is concerned, the key question will not be posed in 1968 -- but in the first half of 1969. Since the ingredients are not at hand for an assessment of the economic outlook for

the early months of next year (and even if they were I would not attempt such a task), I am unable to express a judgment about the probable course of unemployment beyond the end of 1968. But I personally believe that a careful moderation in the expansion of output -- although it might imply slower growth in employment -- is necessary if we are to make a successful attack on the current inflation.

### The Role of Monetary Policy

As I said at the outset, I cannot comment on the future course of monetary policy. However, as I have also said a number of times in the past, I personally believe that monetary policy should always remain flexible and ever-ready to mesh its contributions with other stabilization policies.

Now that fiscal policy has finally joined the fight against inflation, it should no longer be necessary to rely so heavily on monetary restraint in the months ahead. Since the adoption of the fiscal measures in June, there has been a moderate reduction in the pressure on market interest rates. To a considerable extent, these developments probably reflect changes in market expectations as much as recent shifts in actual credit demands.

In any case, mainly for alignment with the lower market rates that had emerged from these circumstances, the discount rate was reduced from 5-1/2 per cent to 5-1/4 per cent at the Federal Reserve Bank of Minneapolis, effective August 16. The same day, the Federal Reserve Bank of Richmond reduced its discount rate to the lower level.

In the end, however, how far the Federal Reserve System goes in blending monetary policy with the new fiscal measures will undoubtedly depend on its own assessment of the continuing pace of inflation and the persistent deficit in our balance of payments. But, in my personal view, as I stressed while the fiscal measures were being debated in Congress, I believe there is a case for some degree of substitution of fiscal for monetary restraint as the effects of the fiscal restraint come into play. This is especially true because the effects of monetary restraint are frequently delayed and partly masked by a web of institutional relationships.

On the basis of my assessment of the economic outlook, I am convinced that there will be moderation in the pace of domestic economic advance in the closing months of 1968 and in the first half of 1969.

Such moderation in activity is exactly what the economy needs if we are to make any headway in checking the current inflation. However, we should also keep in mind that fiscal restraint of the magnitude recently adopted by Congress -- even taken alone -- would have a sizable impact on the economy in the first half of 1969. Previously approved -- but delayed -- social security taxes will also become effective early next year. Thus, we must be careful to insure that the combined effects of our stabilization policies are sufficient to bring inflation under control -- but not so great as to generate a recession which I personally do not think is a suitable cure for inflation.