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Facing Phase IV

Two news items last week had important implications for the price situation. On July 18, the grand design of Phase IV was revealed to the public. Then, on the following day, the second-quarter estimate of gross national product was announced, indicating a substantial slowdown in the overall *growth* of the national economy.

Of these two announcements, the nature of Phase IV controls will have the most immediate bearing upon individual prices of commodities and services, since it represents a shift from a freeze to more flexible controls—on August 12 for nonfood items and on other dates for food items. However, the sharp second-quarter slowdown in the growth rate (despite the somewhat equivocal nature of the evidence) offers some hope of a reduction in excess demand, and thereby some basic easing of inflationary pressures. Even so, these pressures remained severe during the second quarter, as the 6.8-percent rate of price increase was the highest recorded since 1951.

Higher food prices...?
The shift in controls attempts to alleviate one of the major problems of the freeze; that is, the squeeze on food producers caught between, on the one hand, rising costs of feed and other essentials, and on the other, ceiling prices at the retail level. These ceilings have virtually precluded increases in farm prices and have therefore restricted the expansion of agricultural output. Thus, since the key to the stabilization of food is increased production, food prices (other than beef) were released immediately from the freeze and brought under looser Phase IV controls.

Phase IV controls over food prices are perhaps the most complex for any industry or commodity, encompassing as they do one set of (temporary) controls for beef and another set for other food products. The ceiling prices for beef products, which were imposed on March 29, will remain in effect until September 12. Thereafter, prices may rise, to the extent that they reflect cost increases, on a dollar-for-dollar basis.

Prices for other food products were released from the freeze immediately upon the announcement of Phase IV controls on July 18, but they are still subject to certain limitations. They may rise in response to increases that have occurred in the cost of raw agricultural materials since the pre-freeze date of June 8. After September 12, however, food prices (including beef) will be subject to the same conditions of costs, reporting, and prenotification that apply to non-food industries. Thus, the structure of food price controls will fall into place a month after the freeze ceilings on non-food prices give way to Phase IV controls.

... and lower profits?
The changes in allowable cost increases under Phase IV will have a very definite effect upon profits, much more so than the Phase II controls. Under the latter, price

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increases arising from increased costs were controlled by profit-margin limitations. Margins for individual firms were determined by their profits in the average of their best two years of the five years prior to January 11, 1973. Under this arrangement, mark-ups in costs were reflected by corresponding mark-ups in prices—subject, however, to the overall constraint of profit-margin ceilings.

Under Phase IV, changes have been made in both the method of computing allowable cost increases and the base from which costs may be calculated. Formerly, the base price from which cost increases might be determined was the highest price charged for at least 10 percent of total sales in the 30 days prior to August 15, 1971. However, the new base for cost increases is the last fiscal quarter prior to January 11, 1973. Costs incurred *before* that period are no longer allowable as justification for price increases.

As a result of the elimination of costs incurred prior to this January *and* the changeover from margin mark-ups to a dollar-for-dollar cost passthrough, a sizable amount of potential price increases may have been erased, inasmuch as a number of firms had not exercised their full allowable mark-up of prices before the freeze. Although no new profit-margin limitations have been explicitly announced, the Phase IV groundrules may very well have the effect of freezing profit margins at (or below) their level of the fourth quarter of 1972.

Other features

Firms with annual sales of $100 million or more are to be returned to a program of required prenotification of planned price increases under Phase IV. Quarterly reports will be required from firms with annual sales of $50 to 100 million, and annual reports from smaller firms. Companies with fewer than 60 employees are exempt from reporting.

The lumber industry is added to the list of exempt activities, along with rents (decontrolled at the end of Phase II) and raw agricultural products (never controlled). The release of lumber from controls reflects the fact that lumber prices have been falling consistently in recent months.

Wages represent the most singular exception to new Phase IV controls. The limits or guidelines for wage increases continue to be 5.5 percent plus an additional 0.7 percent for fringe benefits. Some recent contracts have exceeded these limits, but not by significant margins. By and large, most of the recent labor contracts have been on the side of moderation.

Slowing in demand?

After six consecutive quarters of substantial *real growth*, the annual rate of growth of physical output dropped from a torrid 8.7 percent in the January-March period to 2.6 percent in the second quarter of 1973. On the face of it, this decline would seem to indicate a rather considerable softening in demand.

In *current-dollar* terms, the rise in total GNP declined from $43 billion to $29 billion between the first and second quarters. Consumer purchases were decidedly less expansive, particularly in the area of consumer durables, which grew by less than 3 percent in the second quarter after rising almost 34 percent in the preceding quarter. Recent consumer-attitude surveys have indicated some consumer apprehension about the outlook, and these uncertainties have been reflected in deteriorating intentions to purchase homes, autos and other big-ticket items.

Along with the decreasing buoyancy in consumer spending went a slowdown in the capital-goods sector. Business fixed-investment spending rose at an 11-percent rate, less than half of the first-quarter rate of gain. Residential construction, although stronger than generally anticipated, rose at a 3.4-percent rate—the smallest quarter-to-quarter increase of the past three years.

The second-quarter statistics are viewed by many observers with more than the usual amount of skepticism. It is their contention that the reported deceleration in consumer spending and business investment is due not so much to a decline in demand as to an inability to deliver goods, because production facilities have been pressed to the limits of capacity. In the second quarter, civilian employment increased by 1 million persons, the unemployment rate finally fell below 5 percent, and personal income rose more than 9 percent, exceeding the first-quarter rate of increase.

Despite the equivocal nature of the evidence, it appears that demand pressures remain quite strong today—witness the price statistics. This points up the fact that today's situation differs considerably from the period of sluggish demand when Phase II was first introduced, and it raises the question whether Phase II's success can be duplicated in such a different atmosphere. The chances of success would brighten considerably if the standard forecast should turn out to be correct, with demand pressures moderating over the next year or so.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 7/11/73	Change from 7/4/73	Change from year ago Dollar	Percent
Loans adjusted and investments *	73,704	− 164	+ 8,795	+ 13.55
Loans adjusted—total*	56,319	− 207	+ 8,722	+ 18.32
Commercial and industrial	19,953	− 173	+ 3,191	+ 19.04
Real estate	16,622	+ 89	+ 2,856	+ 20.75
Consumer instalment	8,393	+ 2	+ 1,332	+ 18.86
U.S. Treasury securities	5,740	+ 10	− 489	− 7.85
Other securities	11,645	+ 33	+ 562	+ 5.07
Deposits (less cash items)—total*	71,659	+ 596	+ 8,777	+ 13.96
Demand deposits adjusted	22,046	+ 1,148	+ 1,951	+ 9.71
U.S. Government deposits	591	− 414	− 63	− 9.63
Time deposits—total*	47,730	+ 28	+ 6,855	+ 16.77
Savings	18,037	− 59	− 174	− 0.96
Other time I.P.C.	20,620	+ 281	+ 5,298	+ 34.58
State and political subdivisions	6,409	− 168	+ 908	+ 16.51
(Large negotiable CD's)	10,113	+ 400	+ 4,801	+ 90.38

Weekly Averages of Daily Figures	Week ended 7/11/73	Week ended 7/4/73	Comparable year-ago period
Member Bank Reserve Position			
Excess reserves	− 19	98	61
Borrowings	135	174	2
Net free (+) / Net borrowed (−)	− 154	− 76	+ 59
Federal Funds—Seven Large Banks			
Interbank Federal funds transactions			
Net purchases (+) / Net sales (−)	+ 843	+ 563	− 845
Transactions: U.S. securities dealers			
Net loans (+) / Net borrowings (−)	+ 121	− 278	+ 99

*Includes items not shown separately.

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