Research Department
Federal Reserve
Bank of
San Francisco

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Cost Push?

Expectations of a resurgence of inflation seem to be gathering momentum, since price increases have been posted in industries which had experienced large declines in output and capacity usage in recent months. This development has led many observers to argue that cost-push factors are generating new inflationary pressures, despite the still-weakened state of the national economy.

Consider what has happened this past month in metals markets, with price increases of 5 percent or more recorded for steel and the major non-ferrous metals. Several reasons can be cited for such price behavior in a period of continued weak demand.

- Increased costs of raw materials and fuel. This is the most obvious cause, especially since fuel costs are largely beyond the control of the individual firm.

- Speculation on the London Metal Exchange. The falling value of the pound in the currency exchanges has led to hedging against the twin possibilities of a further fall in the price of sterling and a further rise in metals prices.

- Customer loyalty. Many purchasers are anxious to maintain good relations with the producers who kept them supplied during the earlier period of shortages, rather than risk these known sources of supply for a current policy of "best price."

- Fear of controls. Metals producers were caught with relatively low price lists prior to the 1971-72 period of price controls. Even a whisper of the re-institution of controls makes them anxious not to be caught with their price lists down again.

Real pressures

The pressures from at least some of these sources are very real. The rise in the cost of fuel and raw materials is quite evident. However, the price increase due to speculation on the London Metals Exchange may be short-lived. Also, customer loyalty may have simply offset some downward pressures rather than contributed to rising prices. On the other hand, the continued discussion of a renewal of controls may have led in some cases to higher list prices.

It should be noted that posted increases in list prices do not automatically result in increased purchase prices. Unfortunately, the wholesale-price index does not make that distinction, but instead tends to overstate prices in recession periods by relying mostly on list quotations. By the same token, it tends to understate the rate of inflation in boom periods.

Prices vs. capacity

That point aside, it may be useful to analyze the cost-push problem by comparing price behavior in certain industries with capacity utilization—or at least with its proxy, the change in industrial production, since capacity fig-

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ures are difficult to obtain on a current basis. Comparison may be made with average industrial output in the second and third quarters of 1973, when capacity utilization in manufacturing reached its peak, and when the unemployment rate (4.8 percent) reached a cyclical low. Thus, the economy was operating at essentially full employment of available resources during that period.

Consider intermediate goods and materials, which account for over 40 percent of the total weight of commodities in the WPI. (These commodities consist in the main of construction materials and general business supplies.) Prices of such commodities continued to rise between mid-1974 and mid-1975, but at a sharply decelerated pace, and that deceleration was accompanied by a drop of about 10 percent in the relevant component of the industrial-production index.

Now consider several specific commodities. Output and capacity in the lumber and wood-products industry was severely affected in the past year by the collapse in housing. As output dropped from about 105 percent of estimated capacity to 75 percent, prices in that sector went from a 25-percent annual rate of increase to an actual 10-percent decline. The profiles of price and capacity changes were about the same for steel-mill products as for lumber; estimated capacity use fell from 110 percent to below 70 percent as the annual rate of price increase went from 40 percent to less than 10 percent. In aluminum products, the fall in capacity use was most precipitate, falling from about 105 percent of base-period output in the first half of 1974 to the mid-50 percent range—while prices went from a 50-percent annual rate of increase to a 15-percent annual rate of decline. In other words, some of the post-control price increases failed to stick when output and capacity utilization fell to recession lows.

Close relationship

These conclusions are tentative, but they suggest that there is still a close relationship between an industry's rate of capacity utilization and its ability to increase prices and make them stick. Recently we have witnessed a rollback of steel price increases from nearly 10 percent to less than 6 percent, and a posted aluminum-price increase of 3 to 5 percent, below the average rate of increase of the overall price index. When prices in general are rising at a rate of 5 percent or so, the price of an individual commodity may be expected to rise at, above, or below this overall average rate, depending upon the relative strength of demand for the particular commodity and the nature of the markets in which it is traded.

The evidence from the wage side roughly parallels the evidence from the materials side. Wage settlements—with and without a cost-of-living adjustment—were lower in the second quarter than at any other time of the past year. Most contracts are still heavily front-loaded, with increases concentrated in the first year of the contract, but again, these first-year settlements were lower than they have been since early 1974.

No cost-push?

The fundamentals thus do not appear to sustain a major cost-push inflation. Particularly important is the tendency for productivity to rise—sometimes sharply—in the early stages of a recovery. The cumulative effect over time is to bring about a more efficient rate of plant operation, which in its turn helps keep cost increases in check.

Some counter-currents still muddy the waters. In the monthly survey of the National Association of Purchasing Management, the respondents reporting higher prices jumped from 22 percent in July to 41 percent in August. But as for expected price behavior for the remainder of 1975, over three-quarters anticipated moderate and selective attempts to raise prices rather than a concerted across-the-board movement. This is consistent with an apparent base-line inflation rate of about 5 percent.

Finally, past business-cycle history exhibits similar patterns of price behavior. In both the 1953-54 and 1957-58 periods, wholesale commodity prices accelerated in the early months of the recovery, but then subsided as the expansion moved along. Consumer prices also rose early in each recovery, reflecting higher costs of food. History does not bind us to follow earlier cyclical patterns, but there are grounds for believing that the recent resurgence of inflation will give way to slower rates of price increase before too long.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 9/03/75	Change from 8/27/75	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	84,995	+ 403	+ 1,094	+ 1.30
Loans (gross, adjusted)—total	64,034	+ 198	– 2,503	– 3.76
Security loans	972	– 23	– 135	– 12.20
Commercial and industrial	22,774	+ 110	– 1,128	– 4.72
Real estate	19,567	– 2	– 249	– 1.26
Consumer instalment	9,943	+ 9	+ 318	+ 3.30
U.S. Treasury securities	8,291	+ 202	+ 3,875	+ 87.75
Other securities	12,670	+ 3	– 278	– 2.15
Deposits (less cash items)—total*	85,380	+ 544	+ 4,880	+ 6.06
Demand deposits (adjusted)	23,587	+ 102	+ 1,468	+ 6.64
U.S. Government deposits	300	– 2	+ 49	+ 19.52
Time deposits—total*	59,762	+ 170	+ 3,539	+ 6.29
States and political subdivisions	5,865	– 62	– 138	– 2.30
Savings deposits	20,700	+ 16	+ 2,945	+ 16.59
Other time deposits‡	29,419	+ 167	+ 387	+ 1.33
Large negotiable CD's	15,596	+ 209	– 232	– 1.47

Weekly Averages of Daily Figures	Week ended 9/03/75	Week ended 8/27/75	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves	73	75	111
Borrowings	12	2	448
Net free (+) / Net borrowed (–)	+ 61	+ 73	– 337
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+) / Net sales (–)	+ 1,236	+ 1,495	+ 821
Transactions of U.S. security dealers			
Net loans (+) / Net borrowings (–)	+ 351	+ 279	+ 580

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

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