

Research Department
Federal Reserve
Bank of
San Francisco

March 12, 1976

Prices in Industry

Optimists can find grounds for hope in the recent deceleration of wholesale industrial prices, which dominate the nation's price statistics. Industrial prices not only account for 77 percent of the entire wholesale price index, but they are far more representative of basic supply-demand conditions in the economy than farm and processed-food prices, which fluctuate widely in response to such factors as changes in the weather. This recent behavior of industrial prices thus provides evidence of an easing in underlying inflationary forces, although some observers warn that inflation could flare up again as the recovery gains momentum.

Industrial prices accelerated from a 3.4-percent annual rate of increase in the first half of 1975 to a 7.9-percent rate of increase in the six-month period ending this February. But most of that bulge occurred last fall, and smaller increases only about one-half that large have been recorded in the past several months. Moreover, the 5.8-percent increase between February 1975 and February 1976 compares strikingly with the 21.9-percent rise of the preceding twelve-month period. Looking ahead, most industry observers—although not expecting this easing to continue—are hopeful that the rate of inflation will remain at a comparatively moderate pace because of relatively high levels of excess capacity and weaker cost-push factors. Hardly anyone expects to see a replay of a 1974-style inflation.

Price bulge: 1974

During 1974, the increase in energy prices was a dominant factor in the industrial price upsurge. Fuel prices soared as domestic producers of petroleum, natural gas and coal responded to the quadrupling of foreign oil prices. These increases in turn helped to push up costs for other manufacturers. Producers of paper, metals, chemicals and other products reacted not only to these cost pressures but also to the prior surge in raw-material costs that had occurred during the 1972-73 commodity boom. In raising their prices, they also sought to eliminate the differentials that had developed between domestic and foreign prices during the price-control era.

Rising labor costs also played a large role in the movement of industrial prices during 1974. Output per manhour declined as business activity slowed, while hourly compensation accelerated because of inflation, so that unit labor costs rose sharply and steadily during every quarter of that year.

Bulge: autumn '75

The price bulge of fall '75 came about as energy producers again boosted list prices sharply and as producers in a number of other industries—steel, aluminum, textiles and others—tried to offset these and other prior cost increases as a means of restoring profit margins to more acceptable levels. To some extent, major material producers were encouraged to boost prices by the increased

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demand for their products, which enabled them to raise their production from 70 to 81 percent of capacity between the first and final quarters of 1975.

However, many of last fall's posted increases—especially those for metals—may have been premature. With excess plant capacity and excess inventories still evident at many facilities, a number of industries have been discounting below list prices—and some have even lowered their posted prices. We should note in this connection a certain bias in the wholesale price index because of its use of list prices rather than transactions prices. (However, official statisticians are trying to use transactions prices wherever possible in calculating the index.) In the early stages of a business recovery, this factor tends to overstate the actual strength of prices by failing to reflect discounting still going on in many industries.

The metals industries in particular have exhibited this behavior. They raised their prices in the summer and fall of 1975, but subsequently had to offer certain products at prices below list as some of their customers—including the auto and

appliance industries—continued to work off excess metal inventories. The demand for these metals has begun to improve significantly only in recent weeks, so that increases in posted metal prices have been confined mainly to raw materials such as iron and steel scrap.

In addition to the discounting prevalent in certain industries, a reduction in fuel prices also has helped moderate price pressures during the past few months. This decline can be traced to a modest drop in imported oil prices, but mostly to the passage of new energy legislation, which establishes a composite ceiling price for domestic oil of \$7.66 per barrel. Under the new pricing formula effective February 1, prices for domestic oil not previously subject to controls were rolled back from about \$13.00 per barrel to \$11.28 per barrel, helping achieve the drop in the composite ceiling price. This rollback, which is still being implemented, will involve about 40 percent of total domestic output.

Cost pressures abated during 1975 because of sharp gains in labor productivity. Private nonfarm productivity rose more than 8 percent in both the spring and summer quarters of the year—as is typical during the early stages of a recovery—reversing the steep recession decline. As a result, unit labor costs actually fell during that period. Bolstered by a rising vol-

ume of sales at higher prices and also by the decline in unit labor costs, manufacturers' profits after taxes rose more than 60 percent between the first and final quarters of 1975. Profit margins—profits per dollar of sales—rose dramatically, reducing the pressure to boost prices further in subsequent months.

Upward pressure?

Despite the recent improvement in industrial prices, further easing in the rate of inflation may be hard to come by. As labor and raw-material costs rise in coming months, many industries may try to pass those increases on to consumers, especially in the atmosphere of improved demand conditions for their products. But the unused capacity still evident in many industries, the absence of special cost-push factors relating to energy, and the moderate advance expected in labor costs should help prevent a sharp rise.

Actually, labor costs already have turned upward. Labor productivity in the private nonfarm sector rose only slightly during the fourth quarter of 1975 as the rate of expansion in economic activity temporarily slowed. As a result, unit labor costs rose at a 6½ percent annual rate during that period. Productivity gains should certainly speed up again, but they are not likely to be as large as in the middle two quarters of 1975. Consequently, unit labor costs may again exert upward pressure on prices.

The amount of this pressure will depend not only upon the rate of productivity growth but on the extent of wage demands. The greatest threat of a strong cost-push nature comes from a possible upsurge in hourly compensation, which could far more than offset the benefits of gains in output per manhour. This year, major collective bargaining agreements will be negotiated for about 4½ million workers—almost twice the number covered by last year's new contracts. The increase in labor costs could accelerate appreciably if 1976 contracts call for hourly compensation to rise much beyond the 8-percent rate experienced last year. Raw-material prices also have turned higher recently, with ominous implications for finished-goods prices.

Despite these influences, the industrial sector in coming months will not have to contend with the types of problems it faced several years ago—such as surging fuel prices or the release of pent-up cost pressures resulting from the ending of wage and price controls. For those reasons, the economy is unlikely to witness a resurgence in industrial price inflation comparable to the 1974 upsurge.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities	Amount Outstanding 2/25/76	Change from 2/18/76	Change from year ago	
			Dollar	Percent
Large Commercial Banks				
Loans (gross, adjusted) and investments*	86,658	- 671	+ 2,346	+ 2.78
Loans (gross, adjusted)—total	64,432	- 294	- 1,507	- 2.29
Security loans	700	- 47	- 435	- 38.33
Commercial and industrial	22,995	- 261	- 1,240	- 5.12
Real estate	19,600	- 9	- 366	- 1.83
Consumer instalment	10,377	+ 12	+ 457	+ 4.61
U.S. Treasury securities	9,572	- 359	+ 3,772	+ 65.03
Other securities	12,654	- 18	+ 81	+ 0.64
Deposits (less cash items)—total*	86,020	- 719	+ 3,084	+ 3.72
Demand deposits (adjusted)	23,233	- 45	+ 1,045	+ 4.71
U.S. Government deposits	317	- 315	+ 6	+ 1.93
Time deposits—total*	61,175	+ 8	+ 1,952	+ 3.30
States and political subdivisions	6,761	- 15	- 306	- 4.33
Savings deposits	24,608	+ 146	+ 5,844	+ 31.14
Other time deposits‡	27,298	- 114	- 3,046	- 10.04
Large negotiable CD's	12,099	- 202	- 4,326	- 26.34
Weekly Averages of Daily Figures	Week ended 2/25/76	Week ended 2/18/76	Comparable year-ago period	
Member Bank Reserve Position				
Excess Reserves	28	48		45
Borrowings	7	8		42
Net free(+)/Net borrowed (-)	+ 21	+ 40		+ 3
Federal Funds—Seven Large Banks				
Interbank Federal fund transactions				
Net purchases (+)/Net sales (-)	+ 1,588	+ 1,989		+ 1,528
Transactions of U.S. security dealers				
Net loans (+)/Net borrowings (-)	+ 101	+ 175		+ 665

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

Editorial comments may be addressed to the editor (William Burke) or to the author. . . . Information on this and other publications can be obtained by calling or writing the Public Information Section, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 544-2184.